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Politics this week

May 17th 2007
From The Economist print edition

AFP

Pakistan was shaken by its worst violence in years amid the crisis surrounding the sacking of the country's top judge. Around 40 people were killed during rioting in Karachi, damaging the attempt of the president, General Pervez Musharraf, to run a military government under a veneer of constitutionality. Separately, a suicide-bomber killed at least 25 people in an attack on a hotel frequented by Afghans in Pakistan's north-western city of Peshawar. See article

Officials in **Afghanistan** displayed the body of Mullah Dadullah, the Taliban's most notorious commander, killed in a battle with American special forces. See article

José Ramos-Horta, a Nobel peace laureate, won a decisive victory in a presidential election in **Timor-Leste** over Francisco Guterres, a former guerrilla running under his *nom-de-guerre*, “Lu-Olo”. See article

A pair of passenger trains crossed the border between **North** and **South Korea** for the first time since 1951, furthering the countries' engagement effort.

Diplomatic offensive

Iranian and **American** diplomats looked likely to meet openly for the first time in 28 years, perhaps by the end of the month, mainly to discuss ways of making Iraq more stable. It was understood that Iran's nuclear question would be kept off the agenda. See article

Fighting in the Gaza Strip between supporters of the two main parts of the **Palestinian** unity administration left at least 40 dead and threatened to destroy the government. See article

Ban Ki-moon, the United Nations secretary-general, said he would ask the Security Council to “take the necessary steps” to set up a proposed tribunal of “international character” to try the suspected assassins of Rafik Hariri, five-times prime minister of **Lebanon**, who was killed two years ago. Lebanon's parliament had reached a stalemate in trying to ratify the tribunal.

Demonstrating its growing ties with **Africa**, China launched a Nigerian communications satellite into orbit, the first time a foreign country had bought both a Chinese satellite and its launching service. See article

African Union (AU) peacekeepers in **Somalia** suffered their biggest loss since they arrived in March when four Ugandans were killed by a roadside bomb in the capital, Mogadishu. America and the AU have warned Ethiopia against withdrawing its troops, who were largely responsible for ending Islamist rule there, until the AU can send thousands more.

Under pressure

AP

More troubles for **Colombia's** president, Álvaro Uribe. He fired the police chief after revelations of illegal phone-tapping of opposition leaders; several of his allies were among 19 politicians and business leaders whose arrests were ordered over ties to right-wing paramilitaries; and a jailed paramilitary leader levelled unsubstantiated allegations that the vice-president and defence minister incited paramilitary action in the 1990s. Both men are known to have met paramilitary leaders, but as part of peace efforts. See article

In **Mexico**, a senior intelligence official in charge of monitoring drug gangs was shot dead as he drove to his office. The country's drug gangs are resisting a crackdown by the government.

In an apparent swipe at Venezuela's president, Hugo Chávez, **Pope Benedict XVI** expressed concern about “authoritarian forms of government” in a speech opening a conference of Latin American bishops in Brazil. He also criticised Marxism and capitalism.

In Brazil, a rancher was convicted of ordering the killing of Dorothy Stang, an American nun and **Amazon rainforest** activist who was murdered on a jungle road in 2005.

Another horse in the race?

The **Republican presidential candidates** held their second debate, with each jostling to prove his conservative credentials. Outside the official field, Fred Thompson, a television actor and former senator, did his undeclared campaign no harm by addressing the Council for National Policy, an umbrella group of conservatives. See article

Jerry Falwell died at the age of 73. Mr Falwell, a pastor and televangelist, was a co-founder of the Moral Majority, a powerful conservative political force during the 1980s. He once said: “The idea that religion and politics don't mix was invented by the devil to keep Christians from running their own country.” See article

Antonio Villaraigosa became the latest mayor to present an “action plan” on climate change, submitting some 50 ideas to help **Los Angeles** cut its emissions by 35% before 2030. Unlike a similar initiative from New York, Mr Villaraigosa steered clear of proposing a congestion charge.

After five years of opposition to a UN convention on the **law of the sea**, George Bush urged the Senate to ratify the treaty. It would enhance the mobility of American armed forces, the president said.

A match made in heaven

Getty Images

Nicolas Sarkozy was inaugurated as **France's new president**. He flew to Berlin to meet Chancellor Angela Merkel and declare that the European Union must be lifted out of its current paralysis. His centre-right government is expected to include a socialist, Bernard Kouchner, as foreign minister. See article

The American secretary of state, Condoleezza Rice, visited Moscow. She and **Russia's** president, Vladimir Putin, agreed to tone down their hostile language, but did not resolve underlying differences. Nor did the German foreign minister, Frank-Walter Steinmeier, who flew to Moscow ahead of a summit. See article

Serbia formed a new coalition government four months after an election. The EU enlargement commissioner promised to talk about accession negotiations, but only if the new government hands over Ratko Mladic, a former Bosnian Serb commander, to the war-crimes tribunal in The Hague. See article

Armenia's parliamentary election was won by pro-government parties. The election was judged by international observers to be much fairer than the previous one in 2003. See article

Gordon Brown secured his position as Britain's next Labour Party leader and prime minister, once Tony Blair goes in June, after vacuuming up the support of the party's MPs. A desultory challenge to Mr Brown from left-wingers failed to get off the ground. See article

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Business this week

May 17th 2007
From The Economist print edition

DaimlerChrysler found a buyer for its troubled North American division. The German carmaker agreed to sell an 80.1% stake in **Chrysler** for $7.4 billion to **Cerberus Capital Management**, which said it would continue with Chrysler's restructuring blueprint and also assume multi-billion-dollar liabilities for workers' health-care and pension plans. Chrysler's biggest labour union welcomed the deal, but negotiations are expected over the management and burden of benefits. See article

Meanwhile, **DaimlerChrysler** reported that quarterly net profit had more than doubled, to *euro*2 billion ($2.6 billion), compared with a year ago because Mercedes, its luxury-car unit, had revved up its performance, offsetting losses from Chrysler.

Raid to rest

Hanson, once one of the world's best-known conglomerates and now a supplier of building materials, agreed to an £8 billion ($15.8 billion) takeover from **HeidelbergCement**. Co-founded by the late Lord Hanson in 1964, the Hanson group made a series of “corporate raids” that gave it diverse interests, including tobacco, gold mining and chemicals. The conglomerate was split in four in 1996. See article

Tyco settled class-action lawsuits brought by shareholders for $3 billion. The conglomerate's share price collapsed in 2002 amid an accounting scandal for which its former boss, Dennis Kozlowski (of the infamous $15,000 umbrella stand) and former finance chief were convicted. It is soon to split into three companies.

Warburg Pincus, a private-equity firm, said it would take over **Bausch & Lomb** in a $4.5 billion deal. The eye-care company was dealt a serious blow last year when it had to recall contact-lens solution that had been found to produce fungal eye infections.

Reuters and **Thomson** made their merger official in an £8.7 billion ($17.2 billion) transaction to create the world's largest provider of financial data. The trustees that uphold Reuters' independence gave their approval, but the deal will be scrutinised over the coming months by competition regulators in America and Europe.

A new housemate

Spain's **Telefónica** sold its 75% stake in **Endemol**, a Dutch media-production company that is responsible for starting the fashion for reality-TV with programmes such as “Big Brother”. The stake was bought for *euro*2.6 billion ($3.5 billion) by a consortium that includes Mediaset, the Italian media group controlled by Silvio Berlusconi, Italy's former prime minister. The low cost of Endemol's programming is a hit with broadcasters worldwide. Telefónica is divesting its interest to focus on its core telecoms business.

Germany's **Merck** said it would sell its generic-drugs business to **Mylan**, based in Pennsylvania, for *euro*4.9 billion ($6.6 billion). The deal provides Mylan with a foothold in 90 countries where Merck retails the drugs, but some analysts fear that the price Mylan is paying, which is greater than its own market value, is too high.

Citigroup had its best day on the stockmarket in four years after it emerged that Edward Lampert, a hedge-fund manager with a reputation for investing in undervalued shares, had bought a stake in the bank worth $800m.

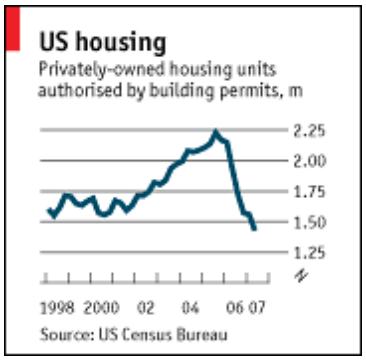
Amazon said it would open a digital-music store later this year, underscoring the desire among online retailers to offer music free from **digital-rights protection** and enable downloads on to all types of music players. Following a similar deal with Apple, EMI will make its catalogue of songs available on Amazon's site.

Harrah's Entertainment declared it would build a casino and resort at Biloxi, Mississippi, that will cost around $1 billion. Named Margaritaville, the venture is being planned together with Jimmy Buffett, a singer-songwriter, and is described by the company as the single largest investment in the Gulf state since Hurricane Katrina struck in 2005.

The **Organisation for Economic Co-operation and Development** invited Chile, Estonia, Israel, Russia and Slovenia to begin membership talks. The Paris-based club of industrialised countries, which has admitted only one member in the past decade, is also strengthening its ties with Brazil, China, India, Indonesia and South Africa.

Falling down

A raft of statistics indicated that the housing market in America is still anaemic and might remain so for some time. The number of **building permits**, a signal of future construction, fell in April to its lowest level for ten years. The housing-market slump continued to have knock-on effects. Quarterly net profit at **Home Depot**, America's biggest home-improvement retailer, dropped by 30%, compared with last year, to $1 billion.



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KAL's cartoon

May 17th 2007
From The Economist print edition

Kevin Kallaugher

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Trade and the economy

America's fear of China

May 17th 2007
From The Economist print edition

China is a far-from-cuddly beast; but bashing it is a bad idea

Kord.com

Get article background

IF THE guest list determined a meeting's value, the Strategic Economic Dialogue between China and America on May 22nd would be a roaring success. Almost half the Chinese cabinet is trooping to Washington, DC, for the second of the twice-yearly discussions, conceived by Hank Paulson, America's treasury secretary, between the world's largest economy and its fastest-growing one. The process was designed, in large part, as an antidote to the latest case of Asiaphobia among America's politicians. It is not working.

The itch to get tough with Beijing is urgent in Congress. Brandishing China's growing bilateral trade surplus as proof, congressmen from both parties have denounced the country as a currency manipulator, an illegal export-subsidiser, a violator of rights to intellectual property and all-round trade scoff-law. China-bashers have introduced a dozen bills in the new Congress. Some are bound to languish, but others may be passed—though there would then be further hurdles to jump, not least the president's power of veto (George Bush has other conflicts on his mind). The most threatening include proposals that would declare China's cheap currency an illegal subsidy and allow American firms to seek compensatory tariffs.

Politics in Beijing is less open, but the circumstances are similarly unhelpful. Because they have no electoral legitimacy, China's Communist leaders need to deliver the economic goods even more than most congressmen do. Worried about unemployment, the Chinese are loth to let their currency, the yuan, appreciate much faster than at today's snail's pace. And as with all dictatorships, there is the need to seem tough. With the five-yearly Communist Party congress only months away, China's president, Hu Jintao, cannot be seen to be bowing to American pressure on the yuan or anything else.

Japanese lessons

Thankfully, an all-out trade war remains unlikely. Congressional leaders seem inclined to act within the rules of the World Trade Organisation (WTO), which limit the scope and scale of any barriers that America can unilaterally impose. And some friction is to be expected in a trading relationship worth well over $300 billion a year. But although today's tensions are not cause for panic, they are a costly and unnecessary distraction—and potentially worse than that.

One worrying parallel is the Japanophobia of the 1980s and early 1990s. Back then, Japan's rising bilateral trade surplus and its mounting foreign-exchange reserves were seen as “proof” of its manipulated currency and mercantilist attitude. America's paranoia deepened as its jobless rate climbed—especially when the Japanese started buying landmarks like the Rockefeller Centre. In fact, Japan's bubble economy ended up bursting; but not before an outbreak of foolish protectionism. The economic tension even undermined support in both countries for America's security alliance with Japan.

The case against China is even weaker than the one against Japan was. Its economy is far more open. Though much poorer than Japan was then, China is already America's fastest-growing export market. And in contrast to the 1980s, the WTO now exists as an umpire for trade disputes. But logic, alas, may count for less than political grievance. America's low unemployment rate looks set to rise in the wake of the housing bust. To American voters, the Chinese are likely to become more prominent rivals, whether it be displacing America at the top of some economic league tables, winning Olympic medals or buying big American firms (the Chinese are rightly keen to diversify from treasury bonds). Most worrying, though, are the strategic risks. Japan was an ally in Asia: China is potentially a military competitor. Trade tensions could make it easier to see China as a rival and harder to enlist it as a partner.

Running such geopolitical risks would be understandable if China's policies posed a true threat to America's economic health. But they do not. China's intellectual-property violations cost American firms far less than many would have you believe: pirated DVDs may sell for peanuts in the markets of Shanghai, but if Hollywood tried to sell the genuine articles at full price, it would quickly discover that most Chinese could not afford them. Similarly, a stronger yuan would do little to dent America's trade deficit (see article).

So much to lose, so little to gain

The bilateral trade imbalance, the target of so many American politicians' anger, is an economic red herring. Its rise reflects changing supply patterns in Asia: America now imports more stuff that has passed through China—and correspondingly fewer goods from South Korea and Taiwan. China's overall surplus and America's overall deficit have less to do with the value of the yuan than with Chinese saving and American profligacy. True, a stronger, more flexible yuan makes sense for China, because it would help shift spending towards imports and would give Beijing's policymakers greater control over interest rates, making it easier to prevent the economy from overheating. But the effect on America would be small.

Rather than picking fights over the currency, Congress should step back and ask why Americans are so upset with China in the first place. The answer is that China is a scapegoat for broader economic anxieties to do with stagnant wages, rising income-inequality and dwindling health and pension benefits. These insecurities, which also lie behind the bad idea of introducing labour standards in trade agreements (see article), are much better tackled head on—at home.

Comprehensive health-care reform to create a system where all Americans have access to portable health insurance would do a lot to reduce workers' anxiety and equip them for an economy that these days demands frequent job shifts. Reform of the payroll tax, a regressive levy that hits the less affluent hardest, would be a good way to shift resources to needier Americans. By contrast, raising barriers to cheap Chinese imports would disproportionately hit the wallets of poor and middle-income American consumers—the very people the Democrats in particular claim to be protecting.

By scaling back its China-bashing, Congress could avoid such blunders. It would also leave more room to engage Chinese officials on subjects that actually matter. Top of the trade agenda ought to be the successful conclusion of the Doha round of global talks. No country has more at stake in a vibrant WTO than China, yet Beijing has been scandalously unwilling to help push for a Doha deal.

But the greatest prizes of Sino-American diplomacy are nothing to do with trade. Avoiding war and conflict, naturally, comes top of the list, whether by co-operation over North Korean and Iranian nukes or by building the trust that minimises the odds of a clash in the Taiwan Strait. Then there is China's expansion into Africa, particularly its cosy relations with genocidal Sudan. Global warming, too, ought to be centre-stage. China is building a new coal-fired power plant every week and is set to surpass America as the biggest source of greenhouse gases within a year. If the world is to contain its carbon emissions, America must not only clean up its own act but also help China to green its economic growth.

Mr Paulson wants the strategic dialogue to address some of these broader issues. Congress should stop

distracting him.

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Pakistan

Time to cut a deal

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General Pervez Musharraf needs allies. Pakistan needs democracy. Enter Benazir Bhutto?

AFP

Get article background

THESE are hard times for the wagers of the war on terror. Tony Blair is about to leave office loathed by many for joining America's intervention in Iraq. George Bush has an Iraq-shy Congress on his case. Meanwhile, Pakistan's uniformed president, General Pervez Musharraf, a key ally in the fight against terrorism, is facing the first large-scale popular protests since he grabbed power eight years ago. The slaughter of around 40 people in Karachi on May 12th and 13th was the country's worst non-sectarian political violence in decades.

Among those who worry about Pakistan, some may be tempted to view the spreading disorder as justification for the general to tighten his autocratic grip. The country looks more unstable than ever (see article). A small war with al-Qaeda supporters along the border with Afghanistan is fuelling a wave of jihadist terrorism. In Islamabad, the extremists are not just at the gate, but inside it. A hardline mosque, staffed by thousands of armed zealots, is defying the government not a mile from the country's Supreme Court and parliament buildings. Indeed, the general's efforts to fight these forces, and his generally pro-American stance, are part of the reason why he has become so unpopular.

But a panicky clampdown will not solve Pakistan's problems. The killing in Karachi was different from the terrorism wave. It was carried out by supporters of the city's thuggish ruling party, part of the weak national coalition through which General Musharraf rules. Many of the victims had gathered to protest against his attempt to sack the head of the country's Supreme Court. They included members of Pakistan's two mainstream parties, led respectively by two exiled former prime ministers, Benazir Bhutto and Nawaz Sharif.

The violence was intolerable. As an effort to stifle legitimate protests against what many Pakistanis consider an attack on judicial independence, it is unlikely to succeed. Pakistan's democracy has been rekindled. And that is a cause for celebration more than worry. Combating militancy in Pakistan, in the tribal areas and elsewhere, requires more than hunting down the militants. Strong democratic institutions are needed to address the disaffections terrorism feeds upon. The irony is that General Musharraf, an enlightened sort of dictator, understands this. He has encouraged the development of a free press and devolved some power to new local administrations. Yet broadly his efforts at controlled democracy have failed.

The general is right when he says that elections alone do not add up to “real democracy”. But nor does a uniformed autocrat who manipulates institutions to maintain his grip on power. This has been the reality

of General Musharraf's rule. His effort to remove Pakistan's chief judge, Iftikhar Chaudhry, was only the latest example.

The reasoning behind the move was dolefully obvious. An election is due this year, which General Musharraf looks determined to survive with all his powers intact. He intends to be re-elected president in the last days of the current parliament. Common sense and Pakistan's constitution both dictate that he should instead seek election from the next one. He may also hope to retain his army uniform, though he is constitutionally obliged to shed it by year's end. So legal challenges lie ahead. And that is why he wants to see the back of the independent-minded and unpredictable Mr Chaudhry.

General Musharraf can do better than this. In aligning himself with America against extremism, and in his commendable efforts to make peace with India, he has shown foresight and a readiness to take the right risks. He needs to do the same now to broaden his political support. Ms Bhutto, who leads Pakistan's biggest and most liberal party, is thought to have offered to support his reform agenda and his re-election as president. Her asking-price, it is said, would be to escape the corruption charges that hang over her, allowing her to return to Pakistan. She also demands a fair election, and that the general should keep to the constitution and shed his uniform.

In praise of the least-bad option

A deal of this sort looks to be Pakistan's least-bad option. Ms Bhutto's demands for her country, if not for herself, are admirable. Pakistan needs genuine democracy, not General Musharraf's imitation of it. But at a time of war and terror, it also needs the continuity and stability that he, the army's man and America's friend, has been able to provide. A return to the chaotic rule that Ms Bhutto and Mr Sharif presided over in the 1990s would be disastrous.

If the general fears that he would lose most from such co-operation, he is wrong. Without greater legitimacy, the opposition will grow and his authority will diminish. He could do a lot worse than seize Ms Bhutto's offer while he can. That is, if it is still open to him after the slaughter in Karachi.

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Zimbabwe's good example

Hot seats

May 17th 2007
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Making bad countries run good causes is actually a promising notion

EPA

Get article background

ZIMBABWE is an odd choice to head the United Nations Commission on Sustainable Development. No one can doubt the sustainability of Robert Mugabe's regime: it has, regrettably, defied countless predictions of collapse. As for development, the country is certainly a striking case study—but of decline, not growth. Few countries offer more vivid advertisement for the connection between sound government and long-term prosperity. The commission's aim is a better life for the many. Zimbabwe is run to provide a high life for the few, involving looted farms and high-spending shopping trips to Dubai and Johannesburg, with increasing misery for everyone else.

But look on the bright side. Few things are more dull than a worthy cause run by a do-gooding country. It is a fair bet that if, say, Sweden or Canada were chairing the commission, nobody outside the aid industry would hear a squeak about its doings over the next year. Zimbabwe's stewardship, by contrast, will attract much scrutiny. Journalists, donors and other critics will be searching for examples of misspent money or—even better—further examples of hypocrisy.

The power of such a spotlight has already been demonstrated: Libya's chairmanship of the UN Human Rights Commission in 2003 helped force that body's transformation into something that—perhaps—requires slightly higher standards. Since then Libya has started to shrug off bits of its roguish reputation, voluntarily ending its nuclear programme.

Chivvying the world's nastiest countries by putting them in charge of good causes is a promising principle. Unimaginative diplomats from west European countries and America are worrying whether Kazakhstan is a suitable country to become chairman of the Organisation for Security and Co-operation in Europe in 2009. Might that honour help nudge reform along? Far better, of course, to put the still more ghastly government of Turkmenistan in the chair. That closed, dictatorial country would find it hard to maintain its isolation through the hectic schedule of chairing a 56-member organisation.

Similarly, putting some notorious narco-state in charge would electrify the UN's sleepily-run drug programme. Saudi Arabia could take over the UN's commission on the status of women. The inter-governmental panel on climate change could be overseen by smoke-belching China. Belarus, which ruthlessly sells weapons of all kinds to anyone with cash, could be asked to take over the UN disarmament department.

You've taken Manhattan; now head for Harare

Moving headquarters might help too: North Korea could inadvertently make an excellent champion of nuclear non-proliferation. The International Atomic Energy Agency's staff might find the austere delights of Pyongyang a bit of a contrast to the cosy comforts of Vienna, but the arrival of dozens of nuclear snoopers would certainly make it harder for the regime there to cover its tracks. Shifting UNESCO headquarters to Riyadh from Paris would highlight the dire state of publishing, science and education in the Arab world. Based in Beijing, the International Labour Organisation would find many more chains to loosen than it does in the workers' paradise of Switzerland. Western countries' weaknesses might benefit from exposure too: the Universal Postal Union could move to Italy.

Of the places in direst need of a spotlight, however, Zimbabwe may be grim, but Sudan is even grimmer, especially its Darfur region, where government-backed militias are still killing people. Sudan has not signed up to it, otherwise the International Criminal Court could be packing its briefcases for Khartoum. Sadly, when it comes to regimes that serially abuse their people, there is plenty of competition.

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International banking

Risk and reward

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From The Economist print edition

Worried about credit risk? You should fret more about pension funds than banks

Getty Images

REMEMBER the days when loans were discussed over lunch at the Rotary Club and sealed with a handshake? Pretty soon, the idea of a banker knowing the name of the person he is lending to—let alone inside details of his credit history—could be as quaint a feature of banking's past as bowler hats and Bonnie and Clyde.

Thanks to technological and financial wizardry, loans are now made with little contact between borrower and lender, and are shuffled around the financial system like so many cards at a poker table. Lately, the results of this “arm's length” banking model have looked reassuringly positive. As our survey in this issue describes, international investment banks such as Goldman Sachs and Deutsche Bank have become vast financial-liquidity factories, turning loans into tradable securities, selling them on and earning record profits as a reward. With banks' risk portfolios more diversified and less stodgy than before, banking crises are rare: the closure of a small bank near Pittsburgh in February was the first such institution in America to fold since June 2004.

Yet just because credit risk is more evenly spread does not necessarily mean the system as a whole is safe. Indeed, it may be prone to less frequent, but more violent, shocks, spreading from individual banks throughout the financial system. Thanks to the relentless dealmaking between financial institutions, if (or rather when) liquidity dries up, risks that the banks think they have outsourced to hedge funds, insurance companies and pension funds might cascade back onto their books.

Three forces have enabled the biggest banks to boost the volume and complexity of financial instruments, and the speed at which they are traded. Each has an element of recklessness. The first is the explosion of credit derivatives, which protect buyers from the risk of default. By selling these, banks have brokered insurance contracts to the new holders of risk that in good times produce steady streams of income, but could require huge payouts if markets ever seize up.

The second is the rating agencies, the new arbiters of credit risk. Banks were once the experts on whom they lent to, with inside knowledge on their borrowers. Now that they sell their exposures, they have blithely passed this responsibility on to outsiders, such as Moody's, Standard & Poor's and Fitch Ratings. The agencies have done fabulously well from the stream of new business, but they are further away from borrowers.

Third, the ability of banks to sell their loans may well have led to a lowering of lending standards. Why double-check somebody's books if you are selling on the risk in a matter of days (or even hours)? That became painfully evident this year after American finance companies lent to needy borrowers with poor

credit records in the “subprime” mortgage market. Borrowing is also getting easier for private-equity firms, one of which this week threw yet more caution to the wind by proposing to buy Chrysler (see article). Banks have started lending to them with worryingly easy-going covenants, which give lenders scant power to intervene if a loan risks going bad.

Basel: more exciting than you thought

Privately, virtually every investment banker expresses nervousness about the hard-to-quantify “tail risks” in the new banking model. Some have built up plump liquidity cushions in case of disaster. But what about the regulators?

The main answer is the Basel 2 banking accord, due to be introduced next year. In terms of banking, it has plainly had a healthy effect: banks have strengthened their risk-management systems and spread their risks—so much so that many should be able to hold less capital against their loans. The danger, however, is that by focusing on the health of banks, the regulators have shunted problems into less supervised realms of the financial system, such as the pensions industry. If pension-fund trustees, with less experience than banks in judging credit risk, have allowed the wrong investments, the consequences would be grave indeed.

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Russia and the West

No divide, no rule

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A troubling new pipeline deal is a symbol of the West's inability to cope with Russia

Reuters

THESE are bleak and unsettling times if you believe that Russia and the West ought to be better friends. By common consent, the mood has not been so icy since Soviet days. Russia says it feels encircled by NATO expansion and proposed American missile defences, patronised on human rights and assailed by double standards. The West finds Russia's pushy foreign policy, increasingly authoritarian manner and growing grip on its energy supplies alarming.

A summit late this week between the European Union and Russia's Vladimir Putin looks likely to agree on nothing; ex-communist countries such as Poland and Lithuania are determined to veto talks on a new partnership agreement so long as they are subject to Russian trade sanctions and other pressure. Visits earlier in the week to Moscow by the American secretary of state, Condoleezza Rice, and by Germany's Frank-Walter Steinmeier, produced only a half-hearted promise to cool some of the more heated rhetoric (see article).

Doing that is no bad thing—but the worst words have come from one side only. Mr Putin recently seemed to liken America to Nazi Germany. Ms Rice merely called trends in Russia “troubling”. The American media are harsher—but, perhaps contrary to Kremlin belief, she is not to blame for that.

The idea of Russia being tricked and humiliated by a mighty, well-organised Western camp led by a power-hungry America is preposterous. The truth is that Russia, having first scared its neighbours into NATO by its bullying behaviour, is currently outmanoeuvring a divided and indecisive West on almost every front—and especially on energy.

Last week Mr Putin struck a crucial if provisional deal with Kazakhstan and Turkmenistan on routing their gas exports to Europe via Russia. Along with his recent schmoozing of Algeria and Qatar, this threatens to exacerbate Europe's energy insecurity, kyboshing the hope of importing large quantities of Central Asian gas without Russian involvement. The idea was to hook up Europe to the region's gas reserves with a new pipeline under the Caspian Sea, and then an existing one through the Caucasus and Turkey. The obstacles to the Caspian scheme are formidable; the Kremlin can offer the Turkmen and Kazakhs incentives, such as unquestioning support for their domestic policies, that the West cannot. But the existing Caucasian pipeline once looked just as unlikely; political will turned it into reality, and could still save the Caspian scheme.

Stand your ground

Russia can hardly be blamed for maximising the economic benefits of its energy riches and geography;

every other poor, resource-rich country does the same. But that does not mean that Europe should simply acquiesce. Whatever the pipeline arrangements, it should aim for greater resilience in the face of Russian pressure. It should liberalise its own energy industries, pay for better gas storage, build more interconnecting pipes and power lines, and invest more in liquefied natural gas terminals. The deeper and more liquid Europe's energy markets are, the harder it is for an outsider to manipulate them.

Most important of all, the West must resist Russia's attempts to pick and choose among its customers. The Kremlin seems not fully to accept that its Baltic, Balkan and central European neighbours are as independent as the countries of western Europe are. The centrepiece of Russian policy is to strike bilateral deals: with the big members of the EU, notably Germany, and with weakly governed new members such as Hungary, Latvia and Bulgaria. By seeming to accept this divide-and-rule policy, the Europeans undermine themselves. That is why the German-backed gas pipeline under the Baltic, and the agreement of Hungary and others to a Russian gas pipeline through the Balkans, are so damaging.

Russia's combination of ruthlessness, ambition and wealth is unique and scary. But it should not be intimidating. Europe should accept that a bad deal with the Kremlin is worse than no deal at all. Germany, in particular, needs to be less fixated on friendship with Russia, no matter what. But there is no need to declare a new cold war, whether over energy supplies or more generally. Europe's dependence on Russia for gas and oil is sure to continue, but need not be harmful. After all, it makes Russia dependent on Europe as its main market; talk of switching supplies to China is a pipedream in the absence of pipelines, which take both years and oodles of money to build. The way to bring more equality to the relationship of bullying supplier and anxious buyer is for Europe to stand united against Russian attempts to divide it.

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Species inflation

Hail Linnaeus

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Conservationists—and polar bears—should heed the lessons of economics

MEPL

“NO SCIENCE in the world is more elevated, more necessary and more useful than economics.” That was the view of Carl Linnaeus, a Swedish naturalist, born three centuries ago this week, who is better remembered for devising the system used to this day to classify living organisms.

Linnaeus sought to reveal what he saw as the divine order of the natural world so that it might be exploited for human benefit. He lived at a time when exploration and trade were bringing new specimens to the attention of European scientists. Those specimens, particularly the plants, were scrutinised as potential crops. At the turn of the 17th century there was no sense of how creatures were related to each other; descriptions and classifications were unsystematic. Linnaeus gave life to an organising hierarchy with kingdoms at the top and species at the bottom.

The system he created has proved both robust and flexible. It survived the rise of evolution. It also survived the discovery of whole categories of organism, such as bacteria, that the Swede never suspected existed. But, rather as John Maynard Keynes observed that “there is no subtler, no surer means of overturning the existing basis of society than to debauch the currency,” so Linnaeus's system is being subtly debauched by over-eager taxonomists, trying to help conservation.

Go forth and multiply

As new areas are explored, the number of species naturally increases (see article). For example, the number of species of monkey, ape and lemur gradually increased until the mid-1960s, when it levelled off. In the mid-1980s, however, it started rising again. Today there are twice as many primate species as there were then. That is not because a new wave of primatologists has emerged, pith-helmeted, from the jungle with hitherto unknown specimens. It is because a lot of established subspecies have been reclassified as species.

Perhaps “reclassified” is not quite the right word. “Rebranded” might be closer. Taxonomists do not always get it right first time, of course, and what looked like one species may rightly later be seen as two. But a suspiciously large number of the new species have turned up in the limited group of big, showy animals known somewhat disparagingly as “charismatic megafauna”—in other words the species that the public, as opposed to the experts, care about.

One reason for this taxonomic inflation is that the idea of a species becoming extinct is easy to grasp, and thus easy to make laws about. Subspecies just do not carry as much political clout. The other is that upgrading subspecies into species simultaneously increases the number of rare species (by fragmenting populations) and augments the biodiversity of a piece of habitat and thus its claim for protection.

In the short term, this strategy helps conservationists by intensifying the perceived threat of extinction. In the long term, as every economist knows, inflation brings devaluation. Rarity is not merely determined by the number of individuals in a species, it is also about how unusual that species is. If there are only two species of elephant, African and Indian, losing one matters a lot. Subdivide the African population, as some taxonomists propose, and perceptions of scarcity may shift.

The trouble is that the idea of what defines a species is a lot more slippery than you might think. Since it is changes in DNA that cause species to evolve apart, looking at DNA should be a good way to divide the natural world. However, it depends which bit of DNA you look at. The standard technique says, for example, that polar bears are just brown bears that happen to be white. This is not good news for those relying on the Endangered Species Act. For a certain sort of Colorado rodent (with, alas, a nose for prime riverfront real estate) the question of whether it is “Preble's meadow jumping mouse” or a boring old meadow jumping mouse may be a matter of life or death: local property developers are on the death side. The Bahamas switched overnight from protecting their raccoons to setting up programmes to eradicate them when a look at the genetic evidence showed the animals were common Northern raccoons, not a separate species.

The 21st-century answer to this 18th-century riddle is that a species is what a taxonomist says it is. Evolution often fails to produce the clear divisions that human thought in general, and the law in particular, prefers to work with. It therefore behoves taxonomists to be honest. If they debase their currency, it will ultimately become valueless. Linnaeus the economist would have known that instinctively.

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On the Bank of Japan, Turkey, Rudy Giuliani, Eurabia, Australia, referendums, guns

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Feeling deflated

SIR – Your article suggesting that it would be wise for Japan's central bank to raise interest rates in order to revive consumption is confused about two very basic points (Economics focus, May 5th). First, the Bank of Japan (BoJ) has an unambiguous mandate to ensure price stability. It equates price stability with a lower inflation rate than has any other central bank, and yet inflation has again fallen below its range. Since the BoJ began raising rates, both survey measures of inflation expectations and bond yields have dipped. The BoJ is already abrogating its responsibility to deliver stable prices and the experience to date suggests there is no reason to believe that further rate increases would help.

Second, you committed the classic mistake of confusing real and nominal interest rates. Consumption and saving decisions depend on choices of eating or storing goods today versus the future; and hence depends on the real rate of interest. Your discussion about the "normal rate" of interest is couched in nominal terms and ignores the fact that if people are again expecting deflation then the real interest rate is already (potentially substantially) above the nominal rate.

Anil Kashyap
Professor of economics and finance
University of Chicago
Chicago

The Kemalist principle

SIR – To conclude that Turks should vote for the Justice and Development (AK) party to keep the army out of Turkey's politics, because democracy is more important than secularism, completely misses the point ("The battle for Turkey's soul", May 5th). The millions of Turks who took to the streets recently want democracy as well as secularism. It is not a case of either/or. Islam strictly defines the role of an individual in society, particularly women; you cannot practise democracy in a Muslim nation like Turkey without the support of a secular state.

Fusun Gencsu
Istanbul

SIR – Recep Tayyip Erdogan, the prime minister, stated his intentions before he was elected when he said: "Democracy is like a streetcar. You ride it until you arrive at your destination and then you step off." If the Islamists gain the presidency, Turkey will eventually become another Iran.

Cahit Kitaplioglu
Scotts Valley, California

SIR – The AK Party has not promoted a single law that directly challenges Turkey's secular system. Turkey's problem is that any form of religious piety is considered to be fundamentalist. That not all Muslims desire *sharia* law is unfathomable to radical secularists. The irony is that they resemble radical Islamists: each wants to control state and society to the exclusion of everyone else. The real divide is between liberal-minded secularists and Muslims who want Turkey to blossom into a more plural, liberal democracy, and illiberal secularists and Islamists whose intolerance is inimical to democracy.

Melinda Negron

Ankara

Giuliani's record

SIR – How can you write an assessment on the pros and cons of Rudy Giuliani ("From America's mayor to America's president?", May 5th) and yet exclude his lack of security preparations for New York? Although Mr Giuliani deserves much credit for some decisions regarding crime in the city, he did not address security following the 1993 attack on the World Trade Centre. Despite this event, emergency response teams were kept disconnected and could not have been less prepared for a second attack. This was a failure in decision-making. The fact that Mr Giuliani campaigns on the idea that he is an expert on security preparation is a travesty and he should be challenged on this.

Josh Saladino
Ridgewood, New Jersey

Review rewind

SIR – Time will tell whether my reflections on Europe's future were unduly pessimistic as your reviewer believes ("Eurabia revisited", May 5th). But I did not (as he quotes me) "echo the fears of some" that Europe risks becoming Eurabia. On at least three occasions I called Eurabia a term "largely misleading" since it does not apply to Britain, to Germany and several other European countries.

Walter Laqueur
Washington, DC

Arid land

SIR – Regarding Australia's water shortage, on a recent visit to Dalby in Queensland, I was told that the local golf club is paying A$1 per kilolitre for water to keep the greens green ("The big dry", April 28th). Yet local irrigators are upset at the prospect of paying a minuscule fraction of that for their water. A good start to fixing the Murray-Darling basin would be to price water sensibly. This would stop its inefficient use, brought about by the current agrarian-socialist policy pursued by governments at all levels.

Brian Marshall
Bardon, Australia

SIR – Water trading is part of the solution, not the problem. If water is valued as a scarce resource and thus becomes more expensive, private investment that encourages water saving and efficiency will become attractive and better reflect the scarce nature of the resource. But those unable to adapt to the changing economics of water must be assisted by government either to restructure or exit the industry with dignity and without financial loss. After all, many of these irrigators or their ancestors were encouraged by earlier governments to settle and develop these properties. They should not pay for the mistakes of the past.

Hector Malano
Melbourne

The will of the people

SIR – It is sad that some people are pushing for another referendum as the solution to the European Union's so-called constitutional crisis (Charlemagne, April 28th). We should require anyone discussing constitutional issues to read Federalist Paper 10. With logic that has withstood 220 years of examination, criticism and trial, James Madison proved that representative government is far superior to direct democracy, with its fluctuating passions and yes-no vicissitudes. Devaluing the role of our representatives by holding occasional referendums, be they binding or not, is a road to chaos.

Hans Wijnberg
Midlaren, the Netherlands

Weapons of destruction

SIR – Stating, as David Bush's letter did, that there is no difference between owning everyday items like knives and baseball bats and owning a gun ignores the relative ease by which a gun can destroy a life (Letters, May 5th). Moreover, the notion that guns have come to symbolise such noble ideals as freedom of expression and individual rights and should therefore face no restrictions is wrongheaded. If one were to follow this line of thinking to its logical conclusion there would be no reason why citizens could not possess nuclear devices in the name of individual freedom.

P. Balachandran
Kochi, India

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Pakistan

A general state of disarray

May 17th 2007 | ISLAMABAD, KARACHI AND LAHORE
From The Economist print edition

AFP

A slaughter in Karachi, and a vengeful judge, are signs that Pervez Musharraf is struggling to remain in power

Get article background

ON MAY 12th the port mega-city of Karachi, a great and seething Asian bazaar, returned to the violence that has scarred its modern history. Around 40 people were killed and scores injured in two days of gun battles. Corpses were dragged from shot-up cars and displayed on the tarmac. Along Shahrah-e-Faisal, the main thoroughfare, shop-fronts were smashed and set ablaze. As the carnage spread, 15,000 police and paramilitary troops stood by, unwilling or unable to intervene.

Many reports suggest the violence was perpetrated by Karachi's ruling party, the Muttahida Qaumi Movement (MQM), an ethnically-based mafia allied with Pakistan's president and army chief, General Pervez Musharraf. Its target was an anti-government rally planned for Karachi on May 12th, at which thousands of lawyers and opposition supporters were to protest against General Musharraf's efforts to remove the head of Pakistan's Supreme Court, Iftikhar Chaudhry. Mr Chaudhry was due to address the rally.

If the MQM meant to deter General Musharraf's opponents with violence, it failed. On May 14th opposition parties called a national strike to condemn the slaughter. They included the parties of two exiled former prime ministers, Benazir Bhutto and Nawaz Sharif, and a coalition of Islamists, the Muttahida Majlis-e-Amal (MMA). The MMA once backed the general, as Islamists in Pakistan usually have; but not any more. With an election due this year, Pakistani democracy is stirring from the coma it slipped into eight years ago, when General Musharraf seized power.

Its awakening, if that is what it is, may be traced to March 9th and a previously unimaginable event. In the presence of six other uniformed generals, at his army headquarters in Rawalpindi, General Musharraf ordered Mr Chaudhry to resign. The judge—eccentric, vain, some say incompetent—had upset his colleagues on the bench, and had given populist rulings against the government. More audaciously, he had demanded investigations into several of an alleged 400 cases where people have disappeared, mostly from his native Baluchistan, where an insurgency is flickering. These were probably the work of the powerful military intelligence agency, whose boss was one of the generals present.

Indeed, wherever Mr Chaudhry heard so much as a rumour of injustice—for example, in the reports of kidnapping and rape that fill the margins of Pakistani newspapers—he summoned officials and demanded investigations. Yet few seem to have loved Mr Chaudhry, until he refused General Musharraf's order to resign.

This was an unprecedented event in Pakistan: a civilian telling a bullying general where to get off. General Musharraf, who has no power to sack judges, has filed a complaint against Mr Chaudhry to the Supreme Court. He alleges that the judge has abused his office, for example by currying favours for his policeman son. Meanwhile, Mr Chaudhry has been reborn as a hero of Pakistan's long-dejected democracy. Egged on by black-jacketed lawyers, who were never so glamorous, he has criss-crossed the country, giving speeches on the sanctity of judicial independence. In a quadrangle of Lahore's elegant British-built high courts, beside a soothing fountain and surrounded by red-brick colonnades, some of these lawyers are on hunger-strike—or, more accurately, skipping lunch.

Ordinary Pakistanis, too, have been flocking to Mr Chaudhry. On May 5th tens of thousands mobbed his car as it crawled 300km (190 miles) from Islamabad to a rally in Lahore. In the middle of Punjab, the army's heartland, this was the first significant popular protest against General Musharraf. It was also the first by secular citizens, as opposed to Pakistan's ever-livid Muslim zealots A week later, the repercussions were felt in Karachi.

A chronology of violence

Mr Chaudhry's plane landed at noon on May 12th, and the violence began. Club-wielding hooligans charged a crowd of lawyers gathered at Karachi's high courts. One suffered a broken leg, another a broken jaw, a third had his teeth smashed in. As crowds of opposition supporters, mostly from Ms Bhutto's Pakistan People's Party (PPP), marched towards the courthouse, they were fired on with automatic weapons from rooftops and road-blocks.

Supporters of the Awami National Party, which represents Pushtuns, the people of north-western Pakistan, were also attacked. This sparked gun battles across Karachi between Pushtuns and Mohajirs—the MQM's community, comprising those, like General Musharraf, who relocated to Pakistan from other parts of British India. Most of the dead were Pushtun. Despite a curfew, this ethnic conflict continued into the next day, raising fears of a return to the tribal war that raged in Karachi in the late 1980s.

As bloodied corpses arrived at the city's main hospital, the MQM held a rally of its own. Ten thousand supporters gathered in Muhammad Ali Jinnah Street, named after Pakistan's refined founding father, to hear Altaf Hussain, the party's leader. Not that Mr Hussain was there. He has lived in London for 15 years, evading allegations of multiple murders. But his telephoned harangue was broadcast live. In the words of Farooq Sattar, Mr Hussain's top representative in the city, “The opposition wants to show that Karachi does not belong to the MQM. We have accepted the challenge.”

At the airport, Mr Chaudhry was manhandled by the police and his retinue of lawyers was ordered to leave Karachi. He returned to Islamabad, where General Musharraf was also addressing a rally. Around 10,000 alleged supporters of the ruling Pakistan Muslim League-Quaid (PML-Q) party gathered in front of Parliament House; some told journalists that they had been made to attend against their will by local officials. After praising his ally, the MQM, General Musharraf said his “heart was bleeding” for Karachi. His hometown's troubles, he said from behind a bullet-proof screen, were caused by Mr Chaudhry and his supporters. “Do not challenge us,” the former commando warned them, to general applause. “We are not cowards like you, we have the power of the people.”

General Musharraf, who has survived at least two assassination attempts, is certainly no coward. But his hold on power is increasingly open to question. Pakistan's media, united in horror at the killings in Karachi, mostly blame him, and even before the recent events his popularity was slipping. According to a poll in February for the International Republican Institute, 54.2% of respondents said they approved of how General Musharraf was doing his job; 26% disapproved. When asked which leader they thought could handle their problems best, 32% picked General Musharraf and 25% Ms Bhutto.

AP

Loud opposition is not advised

In another poll, taken around the same time and circulated privately, the general fared worse. Asked which politician they most agreed with, 29% of respondents picked Ms Bhutto and 21.6% General Musharraf. Some analysts say both polls overstate the general's popularity, since Pakistanis are afraid to speak ill of their uniformed ruler to an unknown questioner. And he is certainly less popular now than when the polls were taken.

But polls are of limited use in predicting his future. General Musharraf does not rule by the will of the people, but dictatorially within a hobbled democratic system. He ostensibly restored democracy in 2002, but meanwhile claimed huge powers for his office. As president, he can dissolve parliament on a whim. As army chief, he controls security policy—from a nasty war against Islamist militants in the northern tribal areas, to the orientation of Pakistan's nuclear arsenal.

This arrangement is cumbersome to manage. It requires a supplicant ruling party to vote through his diktats as handed down by a loyal prime minister, Shaukat Aziz (or “Short Cut”, as Pakistanis know him). And it requires sympathetic Supreme Court judges to head off any constitutional challenges that may arise. Before inviting the Supreme Court to legitimise his coup, General Musharraf felt compelled to sack half its members. Mr Chaudhry was elevated, in 2000, to fill one of the gaps.

In the coming months the judges will have other weighty business to decide. General Musharraf means to get re-elected as president by the current parliament. If he succeeds, he may then ask the next parliament to let him remain army chief, an office he is constitutionally obliged to quit at the end of this year. Long-winded challenges in the Supreme Court are assured. This is why the general's failure to rid himself of a troublesome judge is so serious.

If Mr Chaudhry is dismissed, the clamour against General Musharraf will grow. (On May 14th a Supreme Court judge withdrew from the case against his colleague, and a senior court official who was close to Mr Chaudhry was murdered.) Then again, if Mr Chaudhry keeps his job, the general can hope for no love from the Supreme Court in any constitutional battle ahead. Either way, he will have been weakened.

How to tip an election

Even with a sympathetic judiciary, the forthcoming election represents a challenge for General Musharraf. On the last occasion he was hard-pressed to ensure that a supportive government emerged. The election was manipulated in the PML-Q's favour, yet the PPP won the most votes. General Musharraf's supporters persuaded ten PPP MPs to cross the floor; but the general was still short of the two-thirds majority he needed to change the constitution, until the MMA provided its support.

General Musharraf would struggle to repeat this performance. The popularity of the PML-Q—a rabble of renegades and opportunists recruited from Mr Sharif's party—is falling with the general's own numbers. Meanwhile, the PPP is growing stronger. According to the private poll conducted in February, 22.8% of respondents said they would vote for the “king's party”, as the PML-Q is known; 31.7% chose the PPP. On May 5th, the day Mr Chaudhry's caravan came to Lahore, the PML-Q had to cancel a rival rally for lack of support.

Neither can General Musharraf count on the mullahs. His campaign in the tribal areas, which border the MMA's heartland of North-West Frontier Province, is bloody and hugely unpopular. More broadly, so is the general's pro-America stance. In the private poll, Pakistanis rated India a more trusted ally than America, though America has given Pakistan an estimated $10 billion in aid, much of it military, since 2001. This

puts the mullahs in a bind. The MMA's bearded leader, Fazlur Rehman, is a lifelong accomplice of the army, a man whose alleged corrupt enjoyment of government contracts has earned him the name “Maulana Diesel”. Yet he is now turning up at rallies for Mr Chaudhry to defy dictatorship and defend democracy with the best of them.

After Karachi, the political situation is unstable and hard to predict. Some pundits predict General Musharraf will be forced to step aside, perhaps by the army itself. Failing this, he faces some distasteful choices. He can rig the election, as he did a 2002 referendum on his rule, though this would be more difficult against a pepped-up opposition. It might also annoy America, where support for him is flagging. According to Gary Ackerman, a Democrat who heads a congressional panel on South Asia, “The truth is, for our goals to be achieved in Pakistan, there should be more than one phone number there to dial.”

Alternatively, the general can amend his political system in one of two ways. He can make it more dictatorial. On May 5th Mr Aziz reminded journalists that the government could declare a state of emergency. (The Karachi stockmarket reacted by dropping 3%.) Or the general can expand his coalition, and so become a trifle more democratic.

He has been negotiating with Ms Bhutto about this for some time. She wants General Musharraf to rid her of the corruption charges, brought by Mr Sharif, that have kept her in exile. She would also like him to scrap the two-term limit that he has imposed on the office of prime minister; Ms Bhutto and Mr Sharif have each held the office twice. For his part, General Musharraf wants the PPP to support his policies as a loyal opposition.

The potential benefits of their co-operation are clear. Pakistan's military ruler and its most liberal party have a shared vision of a more tolerant society. The king's party, whose leaders are as conservative as many mullahs, does not. PML-Q has refused to back General Musharraf's more liberal initiatives, including at first his effort last year to overturn sexist laws of evidence that have ensured that over 80% of women prisoners in Pakistan are convicted of fornication, though many of them have been raped. With the PPP's support, this law was partially repealed.

Ms Bhutto, despite much noisy bluster about the sanctity of democracy, would have no principled objection to forming a partnership with General Musharraf. Another irony of Pakistani politics is that, under her leadership, the country's most anti-establishment party has been compliant towards the military establishment. On Ms Bhutto's watch, Pakistan backed the Taliban in Afghanistan and sold nuclear secrets to Iran and North Korea. Mr Sharif, by contrast, the favourite politician of a former army dictator, Zia ul-Haq, proved stickier for the generals. He drove one army chief to resign and tried to sack another, General Musharraf—at which point, the general launched his coup.

In short, if the tide has not turned against General Musharraf, a marriage between the lady and the general looks convenient. But there is a tiny snag. They loathe each other. And they would have ample opportunities for a quick divorce. If, for example, Ms Bhutto unexpectedly swept the election, she might dump the general. And he could press the charges against her at any time. A deal between the pair would perhaps be more of a dalliance, conditional and undeclared.

AFP

Chaudhry, lionised but nervous

But how would Pakistan fare under such an arrangement? It would at least be better than if General Musharraf grabbed power, as he might. According to one of his confidants, the general has developed the usual dictator's tic of thinking himself indispensable. An alliance of convenience between him and Ms Bhutto might also be preferable to restoring the democracy Pakistanis enjoyed in the 1990s, when Ms Bhutto and Mr Sharif conspired against each other and the army conspired against them both. After a decade of the instability and misrule that resulted, many Pakistanis welcomed General Musharraf's coup.

The turn of the wheel

Such has been the political cycle in Pakistan: bad democratic government, yielding to unpopular military government and then to democratic messiness again. It is unclear whether the wheel is about to turn on General Musharraf's rule. But it is a good moment to judge it.

Many of the general's prescriptions have been excellent. In the management of the economy he has trusted sensible technocrats, including Mr Aziz. They have been blessed with an inheritance of liberal reforms and, above all, by booming capital inflows, not only from America. Yet they can take credit for strong economic growth, predicted to be 7% this year.

In foreign relations, too, right-minded policies have borne fruit. In the past three years Pakistan's relations with India have been transformed from semi-war to almost-peace. A final settlement of the two countries' problems, and above all the divided region of Kashmir, remains elusive; the rivals' demands are simply incompatible. Yet General Musharraf has perhaps done more than any leader in either country to nudge them into line.

In both cases he made progress because those most directly affected by his policies, investors and the army, supported him. Where, more often, he has had little support for his policies, they have usually failed. In Baluchistan, Pakistan's biggest and poorest province, where legitimate and longstanding local grievances are stoking an insurgency, General Musharraf's solution has been to bomb the place. In the tribal areas, where chronic banditry and Islamist militancy are now complicated by drug money from Afghanistan and global *jihad*, his heavy-handed intervention has fuelled terrorism across Pakistan. On April 28th the interior minister, Aftab Khan Sherpao, was lucky to survive a suicide bomb in North-West Frontier Province that killed 29 people.

Even with more enlightened policies, solving such problems will take time—almost certainly, more time than the general has. Politics cannot be banished indefinitely, as those corpses in Karachi suggest. And neither, perhaps, can Ms Bhutto.

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The candidates: Hillary Clinton

Her latest incarnation: presidential front-runner

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Corbis/AP/Alamy

The smart money is on Hillary Clinton to win the White House in 2008

HILLARY CLINTON'S appearance at John Hay High School, in Cleveland, earlier this month was a study in political professionalism. Students warmed up the crowd with renditions of great American speeches and songs from “Guys and Dolls”. Democratic dignitaries delivered paeans of praise for school reform. When Mrs Clinton at last appeared she put on a perfectly choreographed performance—speaking without notes, displaying a remarkable knowledge of the school's achievements, and bringing a touch of glamour to a dull Ohio afternoon with her pearls and perfectly coiffed blonde hair.

Mrs Clinton praised the school as an example of public-sector reform at its finest (the school has broken itself up into three smaller schools, introduced longer school days and longer school years, and done all this with the co-operation of the teachers' unions). She talked about what America's cities could achieve if only they had a partner in Washington, DC. And, unlike many of her Democratic opponents, she went out of her way to praise the president's No Child Left Behind Act, claiming that the problems stemmed from shortage of funds rather than the principle of accountability.

Yet, for all that, there was something missing. The school hall was only three-quarters full. The audience consisted mostly of middle-aged or elderly ladies. There was little buzz. The place came to life only when a phalanx of local Democratic dignitaries, led by Stephanie Tubbs Jones, the congresswoman for the 11th congressional district, marched into the hall moments before Mrs Clinton arrived.

Joseph Grassy, a local Democrat who arrived late but nevertheless found a seat near the front, pronounced the event a damp squib compared with a recent Obama happening. Barack Obama had attracted thousands of people—so many that an overflow crowd watched his performance on video screens. The atmosphere was electric. Mrs Clinton's desultory numbers were padded out with operatives who owed their careers to the Democratic Party. But it is Mrs Clinton who is comfortably ahead of her main rival, with (say most polls) a double-digit lead.

Mrs Clinton is the most puzzling of the current crop of presidential candidates. Her front-runner status for the Democratic nomination, in a year in which the Republicans are in turmoil, not to say meltdown, reflects impressive strengths. These start with experience. She spent eight years in the White House in what Bill Clinton once called a “two for the price of one” presidency. She is a popular and successful senator for the country's third-biggest state, re-elected last year with a thumpingly increased vote. She also controls one of the two great political machines in American politics (the other belongs to the Bush dynasty): a machine that can boast everything from brilliant strategists, like Mark Penn, to excoriating critics of her enemies, like Sidney Blumenthal.

Yet she also has striking weaknesses. A leading Republican strategist describes her as strong but brittle. She comes with more political baggage than any senior Democrat who is not named Kennedy. Her husband has a long record of suicidally risky sexual dalliance. Mrs Clinton is the one candidate who could transform the presidential election from an unloseable referendum on Republican failure into a vote on a Democratic candidate about whom almost everyone has strong feelings, many of them intensely hostile.

The oddities do not stop there. Mrs Clinton is the best known of the presidential candidates. She first came to national attention almost 40 years ago when she was the first student to give the commencement address at Wellesley, earning a seven-minute ovation for her efforts. Her autobiography, “Living History”, sold a couple of million copies. There is a shelf-load of Hillary-related books such as “The Case for Hillary Clinton”, which suggests that she is the answer to her party's dreams, and “The Truth About Hillary”, which insinuates that she is a lesbian. Carl Bernstein, of Watergate fame, is publishing a 640-page biography, “A Woman in Charge”, next month.

Yet she is also surprisingly elusive. This is partly because she has a habit of repositioning herself—moving to the political centre as senator for New York and then (in some regards, at least) back to the left as a candidate for the Democratic nomination. Hot for the Iraq invasion in 2003, she blows increasingly cold on Iraq today, though she has never gone so far as to disavow her vote in favour of the war.

But there is more to it than that. As one of the most prominent female baby-boomers, Mrs Clinton is whatever people want to see in her. She is lionised by feminists and demonised by cookie-baking traditionalists. The reality is that she was never exactly the baby-boom radical of legend. She is actually a fairly strait-laced type (certainly when compared with her husband and the young wastrel who became George Bush), who once considered becoming a Methodist minister, and who dutifully followed her husband to Arkansas, subordinating her own career to his.

The road back to the White House

Mrs Clinton's path to the Democratic nomination will be no cakewalk. Mr Obama has striking political talents, most notably a public charisma that Mrs Clinton lacks, and John Edwards has formidable political machines in Iowa, where he consistently tops opinion polls, and in South Carolina, where he was born. But any betting man would still have to go with her. Her lead in the polls has been sustained for many months, and has lately been widening. She stood head and shoulders above all her rivals, notably scoring points off Mr Obama, who seemed lightweight and unsure in comparison, during the first, and so far only, Democratic presidential debate in South Carolina last month.

Mrs Clinton also enjoys a strong lead among one of her party's most important constituencies, white blue-collar workers. Polls consistently show her leading Mr Obama by at least two to one among whites without college degrees. Mr Obama is a hero to those comfortably-off liberals who tune in to National Public Radio, a preacher-politician who seems to represent hope and racial reconciliation. But Mrs Clinton has the edge when it comes to the meat-and-potatoes issues that matter more to blue-collar Americans. If your child is trapped in a bad urban school, if your health care is crushingly expensive, if you are in danger of losing your job, then you may well look to the practical Mrs Clinton rather than the rhetorical Mr Obama. Among black voters, though, Mrs Clinton's early strong lead has eroded in favour of Mr Obama.

What about the general election of November 2008? The most common worry about Mrs Clinton, apart from her husband's extra-curricular activities, is that she is simply too polarising a candidate to win. Undoubtedly she makes enemies: a Gallup poll on May 8th gave her a 47% unfavourable rating compared with 50% favourable. But this will not necessarily be enough to sink her. Mr Bush won in 2004 despite being one of the most divisive presidents in American history. Mrs Clinton does not need to get everybody to love her (though she has done a surprisingly good job of winning over independents and even Republicans in New York state). And to win in 2008, she needs to win only one mid-sized state on top of John Kerry's tally. Here Mrs Clinton's appearance in Cleveland is significant. Mr Kerry had no organisation in Ohio six months before the general election; Mrs Clinton has already made Ms Tubbs Jones the co-chair of her campaign.

Mrs Clinton has plenty of assets that compensate for her polarising reputation. She is one of the most disciplined politicians in the business—a huge advantage in the age of YouTube. She is also one of the most sharp-elbowed, battle-tested in the politics of personal destruction. It is impossible to imagine her being “swiftboated” like Mr Kerry. The Clintons have always regarded politics as a continuation of war by other means, and Mrs Clinton is an even tougher fighter than her husband.

And what if she wins? What sort of president will she make? Her supporters like to point to two clear strengths. The first is her experience in both the White House and Congress. The second is her inheritance of the centrist “Clintonian” creed—which accepts the importance of the market but argues that the government needs to intervene to help the losers.

Neither of these two arguments is wholly persuasive, however. Mrs Clinton seems to be no more endowed with natural political judgment than she is with innate charisma. After all, she is responsible for one of the greatest domestic-policy debacles of recent years—an appallingly mismanaged health-care reform plan (“Hillarycare”), which fell apart as soon as it reached a Democratic Congress and handed a huge political present to the Republicans just in time for the 1994 mid-term elections. Mrs Clinton is also already showing a worrying willingness to sacrifice her Third Way principles to appease the Democratic base. She sounds much more critical of free trade than her husband was in the early 1990s, when the economy was in much worse shape.

Nor is she particularly well equipped to bring reconciliation at home. Her biggest weakness is that she means more of the same when it comes to the vicious partisanship that so mars American politics. Her arrival in the White House would force America to live through a continuation of a bad-tempered soap opera that began in 1992. Politics as restoration leaves a great deal to be desired—particularly when it is the second restoration in a row.

Mrs Clinton looks a great deal stronger on international affairs, the area in which the president has most room to manoeuvre and, these days, the area where a sure hand is most sorely needed. She exudes a sense that she is tough enough to defend America's interests. But at the same time she emphasises the importance of restocking America's soft power and repairing its relations with the rest of the world.

Any Democratic winner will be able to tap into a huge store of goodwill abroad. But Mrs Clinton is better positioned than her rivals to harness this goodwill. She visited more than 80 countries during her years as first lady. She is a consummate networker (meet her briefly at one of the global confabs that she likes to attend and you may well receive a hand-written note saying how interesting it was to talk to you.) Mrs Clinton has also produced the eminently sensible idea of turning her husband, one of the world's most popular politicians, into a roaming ambassador for America. If anti-Americanism is the most troubling of Mr Bush's legacies, Mrs Clinton is probably the best equipped candidate to deal with it.

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Trade and labour standards

A dubious deal

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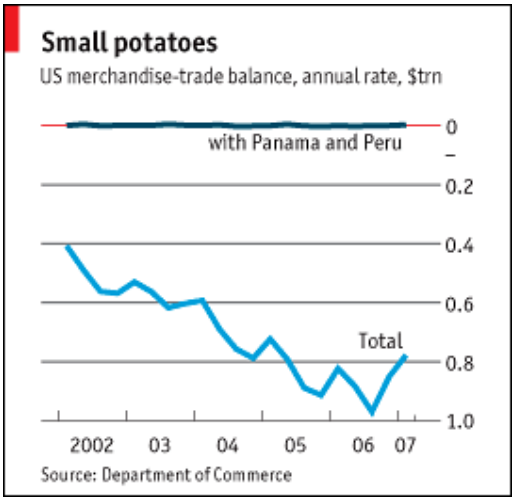
A distinctly underwhelming compromise

THE deal on trade and labour standards struck between congressional Democrats and the White House on May 10th produced much crowing from both sides. Democrats called it “a new trade policy for America”. Susan Schwab, George Bush's trade tsar, talked of having “seized an historic opportunity to restore the bipartisan consensus on trade”.

Not so fast. The agreement is certainly a victory for the Democrats, giving them a long-sought prize: the inclusion of enforceable labour and environmental standards in America's trade agreements. Future trade deals will require signatories to “adopt, maintain and enforce” the five fundamental standards of the International Labour Organisation, which uphold freedom of association and collective bargaining and forbid forced labour, child labour and discrimination. Where previous trade deals have included watery language about workers' rights, the new agreement is tougher, and allows the use of trade sanctions to punish offending countries. The Democrats also forced changes to intellectual-property rules, allowing poor countries quicker access to generic drugs.

And what did the Bush team get in return? Not much. Congress's Democratic leaders promised to pass two small bilateral trade deals, with Peru and Panama, provided the new labour and environmental standards were included. But they balked at backing two others, with Colombia and South Korea. Colombia's government had not done enough to crack down on violence against union leaders, the Democrats complained (see article), and the South Korea deal fell short for American cattle farmers and car firms. Nor did congressional leaders make any promises about extending Mr Bush's fast-track negotiating authority, which expires on June 30th, and which is vital for concluding the Doha round of global trade talks.

At this limping stage of Mr Bush's presidency, it is hardly surprising that the deal was lopsided. The question is whether, despite that, it marked a step forward for free trade. The positive case has little to do with the specific Peru and Panama deals (which, as the chart shows, are irrelevant to America's trade problems). It hangs, instead, on the importance of bipartisanship after years in which the Democrats had become increasingly hostile to all trade deals. Last week's compromise, on this view, was a step towards building the trust and momentum needed for netting bigger fish, particularly a Doha agreement, through Congress. It also cleverly called the bluff of Democratic trade sceptics, particularly the unions, which have consistently argued that they oppose trade deals because of the lack of adequate labour standards.



At the same time, the details of the agreement are worrying. Labour standards are often a pretext for domestic protectionism, and using trade sanctions to punish poor countries may harm poor workers more than help them. The new standards fall short of what America's unions wanted. They are not a back-door route to forcing changes to America's own labour laws. Nor is there much chance of a flood of litigation, since only governments can bring complaints against a trading partner's labour standards. All the same, the direction is the wrong one.

What is more, these standards could make it harder, rather than easier, to conclude a Doha deal. That is because the members of the World Trade Organisation decided more than a decade ago that enforceable labour standards had no business in global trade agreements. If the Democrats try to extend the template to multilateral trade, Doha's prospects, already bleak, darken further. Talking about an “historic breakthrough” for freer trade is distinctly premature.

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Immigration

Debate meets reality

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America's illegal-immigration problems have no easy solution

Get article background

ON CLIMBING-FRAMES in the smarter neighbourhoods of Los Angeles, white toddlers occasionally shout to each other in Spanish. They learn their first words from Mexican nannies who are often working illegally, just like the maids who scrub Angelenos' floors and the gardeners who cut their lawns. Which helps to explain why fixing America's broken immigration system is proving so difficult. Californians, no less than the residents of other states, find illegal immigration distasteful. Yet they depend on immigrants for even such intimate tasks as bringing up their children.

This week the Senate was trying again to reconcile these contradictory, not to say hypocritical, impulses. As *The Economist* went to press, it seemed close to thrashing out a bipartisan bill that holds out the promise of legalisation for the nation's roughly 12m illegals, some 2.5m of them in California alone. But their cases will not be considered until the border is deemed to have been made more secure and the current backlog of legal immigrants is cleared—something that will take at least eight years. Worse, from the immigrants' point of view, they will probably have to leave the country and then petition to return, in what is known as “touch-back”.

If it becomes law, the Senate bill will transform America's immigration system. Following the lead of Canada, Australia, New Zealand and Britain, America would adopt a points system that will give priority to the sort of young, employable immigrants who are most likely to contribute to the economy. Family ties, paramount in deciding immigration claims since the 1960s, would become less important.

A national compromise on immigration is sorely needed. As politicians in Washington, DC, have dithered in the past few years, local governments have increasingly taken matters into their own hands. Costa Mesa, in southern California, has asked its police force to root out and deport illegal immigrants who are arrested for crimes, in effect doing federal agents' jobs for them. On May 12th the residents of a Dallas suburb voted to fine landlords who rent to illegals.

Immigrant advocates have become more militant, too. Last year huge, mostly orderly crowds gathered on the streets of Los Angeles, Chicago and other cities to protest against a bill, passed by the House of Representatives, that would have criminalised illegal immigrants. Many carried American flags. Rallies earlier this month, by contrast, were dominated by professional protesters. In Los Angeles a small and occasionally angry crowd clashed with police. Protesters have called for another rally next month in Hollywood.

Although the pressure for reform appears overwhelming, it is not clear that a deal can be done this year. Compromise may prove more elusive in the House of Representatives. Because of the way that congressional districts are drawn, many politicians represent constituencies with large numbers of ethnic minorities or hardly any at all. And, although George Bush is keen on immigration reform, some of the president's would-be successors insist that there must be no amnesty for illegality. On May 15th Mitt Romney attacked John McCain for co-operating with Democrats on immigration.

Nor is it clear that the Senate plan would bring illegal immigrants out of the shadows. Those who have American children (up to 40% of those in California) will be reluctant to “touch-back”. Much will also depend on how many visas are made available to unskilled workers. If there are too few, the supply of immigrant labour will surely continue to meet the demand for it, regardless of what the law says.

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Michael Bloomberg

Just a New York conversation

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Is another mayor getting national ambitions?

Get article background

SURROUNDED by colleagues from all over the world, plus a fair few corporate leaders, Michael Bloomberg hosted a summit of mayors this week to debate climate change. He criticised national governments for not doing enough. He blamed partisanship for America's immobilisation. He gave warning that if governments don't act, he and the other mayors will.

To the suspicious, it all sounded distinctly like a campaign speech, and it got the pundits twittering. Every day seems to bring fresh speculation on a possible presidential run by New York's current mayor, in which he would compete against his predecessor, Rudy Giuliani, who is already in the race. Mr Bloomberg's face has been on the cover of *Fortune* and he was chosen as one of *Time* magazine's most influential leaders, alongside Hillary Clinton and Barack Obama. He himself openly wonders whether a short, Jewish, divorced billionaire could ever be president—yet does little to dispel the rumours. He relaunched his campaign website last week, which further fuelled the talk. Recent visits to Oklahoma, Houston and Mexico seem a lot like campaign trips. His pet projects—sustainability, gun control, immigration, education, (New York's) global competitiveness—sound a lot like a platform.

Others have noticed too. Robert Rubin, a former treasury secretary, described the mayor as sounding “presidential” at a recent conference. Ed Koch, another former mayor of New York, thinks he will run and has a good chance of winning. Rupert Murdoch has reportedly said that Mr Bloomberg is his preferred choice. Al Sharpton, a civil-rights activist and former candidate, described him as Ross Perot with a resumé.

Like Mr Perot, Mr Bloomberg (if he goes for it) would probably run as an independent, which would suit the many Americans who are fed up with the two big parties. Though he is now a Republican, Mr Bloomberg was for decades a Democrat; he switched parties to run for mayor in 2001. With some of the deepest pockets around, he will not have to hustle for the $500m a bid would cost, which gives him the luxury of delaying a decision until well into next year. But all bar two of America's states choose their presidential electors on a winner-takes-all basis, and breaking the two parties' lock on the vital big states is no easy matter, even for a billionaire.

Selfishly, *The Economist* would like to see a genuine social and economic liberal in the race. But not everyone is convinced. Cynics point out that all this speculation is a great way of keeping Mr Bloomberg's name in lights, and avoiding the lame-duckery that has so crippled the man now in the White House.

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The Republicans

Rudy McRomney and the rest

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The front-runners pull away

THERE were ten men on the stage, but only three counted. The front-runners for the Republican nomination—Rudy Giuliani, John McCain and Mitt Romney—all gave solid performances at their second debate, which was held on May 15th in South Carolina. As for the second-tier candidates—Sam Brownback, Jim Gilmore, Duncan Hunter, Mike Huckabee, Ron Paul, Tom Tancredo and Tommy Thompson—most seemed likeable enough, but none looked like a winner. The Republican grassroots started to mutter that some or all of them should drop out of the race.

The night's biggest cheer went to Mr Giuliani, a former mayor of New York. Republican primary voters have grave misgivings about him, largely because he thinks abortion should remain legal. But they respect him for his unflappability when the twin towers were attacked. During the debate Ron Paul, a feisty libertarian from Texas who stands no chance at all, suggested that Middle Eastern terrorists attacked America “because we've been over there; we've been bombing Iraq for ten years.” Mr Giuliani fired back: “That's an extraordinary statement...that we invited the attack because we were attacking Iraq. I don't think I've heard that before, and I've heard some pretty absurd explanations for September 11th.” The conservative audience erupted in approval.

Mr Romney, a former governor of Massachusetts, came across so smoothly in the first debate earlier this month that *Time* put him on its cover with the line: “Sure, he looks like a president. But what does Mitt Romney really believe?” This week he still sounded presidential, but he is taking a lot more flak. Some of that is for being a Mormon (anti-Mormon tracts are being e-mailed to conservatives), but there is also his suspiciously recent conversion to the abortion-banning camp.

In the debate Mr Romney traded barbs with Mr McCain, a senator from Arizona who has run for president before. Conservatives' chief beefs against Mr McCain are that he is liberal on immigration and favours what many see as unconstitutional curbs on political donations. Mr Romney reminded the audience that his opponent has co-sponsored laws with two Democrats whom Republicans despise—an immigration bill with Ted Kennedy and a campaign-finance bill with Russ Feingold. Mr McCain shot back that he had been consistent on campaign finance and added, in a dig at Mr Romney's alleged opportunism, that he had not changed his position in even-numbered years or “because of the different offices that I may be running for”. Overall, Mr McCain fared better than at the first debate, when he sounded too angry and too old.

The top three all sought to sound tough on terrorism. Mr Romney recommended doubling the size of the prison camp at Guantánamo Bay. Mr McCain urged that the surge of American troops in Iraq be given time to work and that the Iraqi government shape up. He also took a firm stand against torture, whereas Mr Giuliani and Mr Romney fudged. When he was being tortured in Vietnam, he said, he was sustained by knowing his captors would not suffer the same if roles were reversed.

With eight months to go before the first primary, it is still far too early to make predictions. Wild cards such as Fred Thompson, a popular actor and former senator, may yet enter the race. In the end, the party will probably pick whomever its members think can beat Hillary Clinton. Meanwhile Fox News, which broadcast the debate, continued its tradition of balancing good-looking conservative pundits with liberals who look either weird or bearded.

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Electronic discovery

Of bytes and briefs

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The courts are struggling to cope with information technology

A CHICAGO law firm recently put up a billboard with the slogan “Life's short. Get a divorce.” Also on the billboard were pictures of a hot babe in her underwear and a hot hunk in a towel—a sample of the delights that await the newly single. This is the kind of lawyer story that makes the evening news. Deeper, broader problems with America's legal system tend to be ignored. Electronic discovery is one.

What's that? Well, let's say you follow that Chicago law firm's advice and sue for divorce. And let's say your soon-to-be ex-spouse gets angry. His or her lawyers might then demand to inspect your hard drive so that they can, for example, acquaint the court with your love of porn before it decides who keeps the children.

As technology changes the way people communicate, the legal system is stumbling to keep up. The “discovery” process, whereby both parties to a lawsuit share relevant documents with each other, used to involve physically handing over a few boxes of papers. But now that most documents are created and stored electronically, it is mostly about retrieving files from computers. This has two important consequences.

First, e-discovery is more intrusive than the traditional sort. Catty or salacious gossip, the kind that was once swapped at the water cooler, is now often committed to e-mail. This is easy to subpoena and virtually impossible to erase. There is always a back-up somewhere, so even if you delete the e-mail privately denigrating a stock you are publicly urging your clients to buy, it will still be read out in court. If your firm is sued for sexual discrimination, expect the plaintiff to demand all the lewd e-mails your male executives have ever swapped with each other.

Second, e-discovery is more burdensome than the old sort. In the old days, if a big firm was sued, it might have to produce half a million documents, says Malcolm Wheeler, a lawyer who represents big corporate clients in Denver, Colorado. Now, it would have to produce many times that: e-mails, attachments, voicemail recordings and so forth. This can be fiendishly expensive. In a recent case, says Mr Wheeler, his client had to pay 31 lawyers to spend six months ploughing through electronic documents just to figure out which ones ought to be handed over the plaintiff. There is a danger, he says, that big firms will settle with frivolous plaintiffs just to avoid the costs of disclosure, which in turn will encourage more frivolous lawsuits.

Mr Wheeler ranks e-discovery as “the single most significant change to the legal system” since he left law school in 1969. Richard Baer, the top in-house lawyer for Qwest, a telecoms firm, will not go quite so far, but he agrees that it is a problem. He thinks his firm spends at least 25% more on legal fees relating to discovery than it did two years ago. What worries him more is that the rules are so unclear. Do you have to save every version of every document and every fiddle to a computer-aided design? How do you decide what is relevant?

On May 16th a think-tank called the Institute for the Advancement of the American Legal System, at the University of Denver, suggested some guidelines. One is that the rules need to be clearer, especially in the states. Another is that judges need to familiarise themselves with the relevant technology, so they can make informed rulings as to whether a disclosure request is reasonable. They should also learn about, and alert litigants to the existence of, software tools that allow quicker searches for relevant documents. If judges understand what e-discovery is about, they are more likely to issue coherent precedents. If not, the legal system risks being over-loaded.

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Lexington

God without the godfather

May 17th 2007
From The Economist print edition

Kevin Kallaugher

How will the religious right get on without Jerry Falwell?

Get article background

JERRY FALWELL'S death this week came at a time when the movement he helped create is in the doldrums. Social conservatives took a drubbing in the 2006 mid-term elections. The religious right lacks a plausible presidential candidate: the Republican front-runner, Rudy Giuliani, is a liberal on most social issues. The movement's leadership looks eccentric and out of touch. So Mr Falwell's death provokes questions about the future as well as reflections on the past. Why did he and the religious right play such a prominent role in American politics over the past 30 years? And are we seeing the beginning of its end?

Mr Falwell was a quintessentially American type: a poor man who won fame and fortune by preaching the Word. He was born in the hardscrabble South. His father was a drunk who killed his own brother in a gunfight. His academic credentials came from a Bible college. But he proved that he had a genius for religious entrepreneurialism.

He began his ministry in 1956 in a disused soda-bottling plant in Lynchburg, Virginia, with a congregation numbering only a handful. By 1964 his church could seat thousands. By the time of his death his religious empire boasted a church with a congregation of 24,000, a school, a house for alcoholics, a summer camp for children and its own Liberty University.

Mr Falwell preached old-time religion—insisting on the literal truth of the Bible and fulminating against smoking, drinking and short skirts. But he succeeded in part because of his enthusiastic embrace of the fruits of modernity. His daily talks were broadcast on hundreds of radio stations. His choir featured a group of attractive women who had “Charlie's Angels” hairstyles. He had no problem with the prosperity that was transforming the South, living in an impressive mansion and usually appearing in public in a three-piece suit. God blesses those who follow Him.

Mr Falwell was a reluctant convert to politics. Ever since the Scopes Monkey trial in 1925, evangelicals had shunned the national political scene. If they voted, they voted for the Democratic Party, the ancestral home of white Southerners; but they had no time for political activism. Mr Falwell castigated the clergy's involvement in the black civil-rights movement on the ground that “preachers are not called to be politicians but to be soul-winners.”

Two things changed all this. The first was the leftward drift of the Supreme Court, which in the 1960s and 1970s issued a series of judgments on school prayer, pornography and, above all, on abortion that

infuriated evangelicals. The second was the Carter administration. Evangelicals at first embraced Jimmy Carter as a kindred soul. But they were so infuriated by his presidency that they defected *en masse* to the Republican Party. “I know you can't endorse me,” Ronald Reagan told a crowd of cheering evangelicals in Dallas, “but I endorse you.” White evangelicals who had split their vote almost evenly between Carter and Gerald Ford in 1976 broke two to one for Reagan in 1980.

Once he had discovered conservative politics Mr Falwell embraced it with religious fervour—applying his organisational skills to political activism and helping shift millions of conservative Christians into the Republican Party. “If you would like to know where I am politically,” he once said, “I am to the right of wherever you are. I thought Goldwater was too liberal.” He helped to create the Moral Majority, which he defined as “pro-life, pro-family, pro-morality and pro-American”. He organised a series of “I love America” rallies in state capitals. He put aside generations of anti-Catholic prejudice to form a close working relationship with conservative Catholics.

The religious right fundamentally changed American politics. It shifted a huge block of former Democrats to the Republican Party. It moved the Republicans' centre of gravity from the north-east to the sunbelt and from the country club to the evangelical church. It fought American liberals to a standstill on issues such as abortion and gay marriage. It ensured that American politics would turn on cultural issues as much as economic ones. But it is increasingly clear that the evangelical movement needs to reform if it is to preserve that influence.

The descent into bigotry

Mr Falwell himself was a leading indicator of his movement's growing problems. He could be courtly and amusing in person. But he had a gift for putting his foot in his mouth. And he increasingly came across not just as a crank but as a bigoted and divisive crank. In the wake of September 11th, 2001, he and his friend Pat Robertson publicly blamed the terrorist attacks on homosexuality and lesbianism, which had persuaded God to remove his protective mantle from America. In one of his last ventures into the political sphere he argued that he and his followers would rather vote for the devil himself than for Hillary Clinton. He still had some influence—enough to persuade John McCain to travel to Liberty University to give the commencement address—but he was also becoming something of a joke.

Mr Falwell was not alone. Mr Robertson was even more given to outrageous statements, such as when he said Ariel Sharon's stroke was God's punishment for giving away Israeli land. James Dobson, the founder of Focus on the Family, is sounding increasingly off-kilter. Even more worrying for the religious right is the fact that younger leaders like the head of the Family Research Council, Tony Perkins, also sound bitter and divisive.

The evangelical movement that was prodded out of its slumbers in the late 1970s will remain a powerful force in American political life. It will continue to put abortion and gay marriage at the heart of politics. But it needs to broaden its agenda to include issues like the environment. And it needs to embrace a new generation of leaders who are cut from a rather different cloth than Mr Falwell.

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Colombia

Trade, death and drugs

May 17th 2007 | BOGOTÁ
From The Economist print edition

Panos

An argument over the murders of trade unionists is the latest surge in a sea of trouble surrounding Álvaro Uribe's government

Get article background

EIGHT days after workers at a company exporting ornamental plants in Antioquia in northern Colombia informed the management that they planned to form a union, the death threats began. “If you persist with that idea we will have to dissuade you with bullets,” reads a letter sent in January to Ancizo López, the president of the newly formed union. Later came threatening phone calls, a shotgun fired at the door of his home and graffiti on his street reading “death to [guerrilla] collaborators.”

Mr López is still alive and so is his union. But others have not been as fortunate. International labour organisations consider Colombia the most dangerous country in the world for trade unionists. The government says 60 union members were murdered in 2006, and nine have been killed so far this year. Union sources put the figure for last year at 72.

The fate of trade unionists seems set to put paid to Colombia's chances of securing a free-trade agreement with the United States. The Democrats who control the American Congress reached a deal with the administration on May 10th to ratify similar agreements with Panama and Peru. Colombia's was excluded because of the trade-union issue.

To make matters worse for Álvaro Uribe, Colombia's president, the argument over ratifying the trade agreement comes as he faces almost weekly new claims of links between his supporters and right-wing paramilitary militias. The government argues that such claims are being made only because of the big improvement in security achieved by Mr Uribe in his first term from 2002 to 2006.

Mr Uribe took that argument to Washington, DC earlier this month. He personally lobbied many leading Democrats to try to convince them that under his watch Colombia has become safer for trade unionists. Even on the unions' own figures, murders have fallen to less than two-fifths of the number in 2001.

There are two further strands to the government's pitch. First, it has taken steps to protect union activists and to investigate the murders. Second, officials say that, while in the past trade unionists may have been killed because of their activism, nowadays most of the deaths are for unrelated reasons. Colombia, after all, is still a violent country in which people of all backgrounds are victims of crime. The government does not object to international pressure on the trade-union issue, says Carlos Franco, Mr Uribe's human-rights adviser, but “first it should be reasonable and second it should be objective.”

These arguments cut little ice with the Democrats and NGOs in the United States—or with trade unionists in Colombia. Congress should not give Mr Uribe the “prize” of the trade agreement while past killings of

unionists remain unpunished and murders continue, argues Maria McFarland of Human Rights Watch, a New York-based group.

Like many other sections of Colombian society, unions have been caught up in the conflict between left-wing guerrillas, their paramilitary foes and other violent drug gangs. In the past, the guerrillas recruited union leaders as part of their strategy of combining armed action with political agitation. Paramilitaries have tended to equate union activity with support for the guerrillas.

All the main union federations now reject violence. But “the perception remains that unions are troublemakers,” says Elver Herrera of the Escuela Nacional Sindical (ENS), a union-related think-tank based in Medellín. He adds that because of that perception and the attendant danger, only 4.8% of Colombian workers are unionised, compared with 13% in the United States.

The ENS says many unionists were killed during contract negotiations or strikes, though it keeps no specific statistics on this. In the most shocking allegation, Jorge Noguera, who headed a civilian intelligence agency from 2002-05, is facing criminal charges over claims that he provided paramilitaries with a list of trade unionists under government protection. Several of those listed were later killed.

Because so few of the murders have been investigated, in many cases it is hard to determine the motive. In 98.8% of cases, nobody has been punished, says Domingo Tovar of the CUT, the main trade-union confederation—though that is down from 99.9% last year. In the past 18 months, prosecutors have secured 50 convictions in 37 cases. In January, the attorney-general's office set up a special unit with 13 prosecutors and 78 investigators to probe 200 “priority” cases among more than 2,000 unsolved killings of trade unionists reported between 1991 and 2006.

The unit stems from an agreement last year between the government, the unions and business leaders after talks brokered by the International Labour Organisation. The ILO has set up an office in Colombia to monitor labour issues. Luis Carlos Villegas, who heads the main business federation, says that he and the main union leaders have lunch once a month with Mr Uribe to discuss these questions.

Whatever the record in the past, Mr Uribe's government can point to some progress in making Colombia safe for trade unions. But that message is being drowned out amid mounting evidence—as well as improbable claims—concerning the infiltration of politics by the paramilitaries. On May 14th, the authorities ordered the arrest of 19 politicians and businessmen, including five congressmen. They join another eight legislators already behind bars. All are from the north coast, where the paramilitaries were especially powerful.

Originally formed to fight kidnapping and extortion by the guerrillas, the paramilitaries ended up controlling politics and drug-trafficking in areas under their control. Most of them have now demobilised under a peace agreement in which their leaders were offered reduced sentences in return for confessing crimes and compensating victims. Since last year, more than 60 leaders have been in jail.

But they continue to cause problems for the government. This week, *Semana*, a newsmagazine, published transcripts of telephone conversations in which the jailed chiefs gave orders about drug shipments and murders. These were only part of a wider illegal phone-tapping exercise whose targets included opposition leaders. Mr Uribe reacted by sacking the police chief for the phone-tapping. His replacement, Oscar Naranjo, has a reputation for integrity and competence.

The paramilitaries disarmed because their leaders expected to escape serious punishment. Now many face jail terms. This week, in what looked like retaliation, Salvatore Mancuso, the top warlord, claimed that Francisco Santos, Mr Uribe's vice-president, and Juan Manuel Santos, his defence minister, had both incited paramilitary actions during the 1990s. Mr Uribe dismissed the claim, for which there is no supporting evidence.

There is little doubt that some of Mr Uribe's supporters had links with the paramilitaries, just as many on the left in Colombia once had ties to guerrilla groups. The president's underlying argument is that only tighter security, a stronger state and the rule of law will allow trade unionists, like other Colombians, to live safely. Getting there means boosting the relative size of the legal economy. Cocaine consumers in the United States, Europe and elsewhere pump some $3 billion-5 billion a year into Colombia, most of which goes to the guerrillas and the paramilitaries. They will be among the first to rejoice if the Democrats kill the trade agreement.

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Argentina

The first lady steps out

May 17th 2007 | BUENOS AIRES
From The Economist print edition

Cristina Kirchner prepares for the presidency

AN OFFICIAL announcement is not expected until next month, and may come even later. But all the signs—including leaks from senior ministers—are that the Kirchner family candidate in a presidential election due in October will not be Néstor, the incumbent, but Cristina Fernández de Kirchner, the first lady. Since the economy is growing at over 8% for the fifth successive year and the opposition to the ruling Peronists is in disarray, either can be expected to win handily. But why might Mr Kirchner yield to his wife, a senator and an experienced politician in her own right?

Opponents say that his government is losing credibility. It has massaged the inflation figures, and has been tarred by a bribery scandal. Its grip over unions and social movements is eroding; on May 12th teachers demanding higher salaries in Mr Kirchner's home province jostled and threw eggs at his sister, Alicia, the social-development minister.

But polls suggest Mr Kirchner would win even more easily than his wife. Officials hint that the switch of candidate corresponds to changing times. By facing down foreign creditors and keeping a tight grip on the Peronist street, Mr Kirchner helped Argentina recover from its economic collapse of 2001-02, they say. His more moderate wife would be better at repairing relations with the outside world and might appeal to middle-class voters alienated by her husband's impatience with checks and balances.

If Ms Fernández is indeed the next president, the biggest change might come in foreign policy. That is a subject for which Mr Kirchner has shown extraordinary disdain—he notoriously stood up Queen Beatrix of the Netherlands when she made a state visit to Argentina last year. By contrast, Ms Fernández has made a string of foreign visits in recent months, signing agreements in the president's name.

She would probably seek to distance Argentina from Hugo Chávez, Venezuela's leftist president. She has close ties with several American politicians. “If she is president, the relationship [with the United States] will change,” says Héctor Timerman, the Argentine consul in New York. A better rapport might make Argentina more palatable to investors and help the country restructure the $7 billion it owes to other governments.

At home, she might be less confrontational than her husband, and less concerned to micro-manage Congress and the cabinet. But all this adds up to nuances of difference, rather than a change of course. And if she does become president, what role would be played by the First Man? He might continue to manage relations with the Peronist base. “I hope Cristina doesn't kick me out” of the presidential residence, Mr Kirchner has reportedly said. Doubtless his continued occupancy would be part of the deal.

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Canada

Mother knows best

May 17th 2007 | MONTREAL
From The Economist print edition

A new leader for chastened separatists

Reuters

Marois, at the second attempt

Get article background

JUST 18 months ago, the Parti Québécois (PQ) decided that Pauline Marois was not the leader it needed to carry the standard of independence for Canada's huge French-speaking province. She was experienced, able, attractive and reassuring in a motherly sort of way. But the party wanted rejuvenation. It turned to André Boisclair, still in his 30s and openly gay.

On May 8th, six weeks after leading the PQ to a humiliating third-place finish in a provincial election, Mr Boisclair resigned. Before it has officially begun, the contest to replace him is effectively over. With a fervour that smacks of desperation, Ms Marois is being acclaimed by the members as the answer to all that ails the party.

That came as a surprise. The Canadian media had proclaimed the front-runner to be Gilles Duceppe, the leader of the Bloc Québécois, the separatist delegation to the federal parliament. He had pushed for Mr Boisclair's departure and was the first to declare his candidacy—only to withdraw it a day later. In the interim, Ms Marois had said she was standing, and with the backing of a formidable group of PQ deputies. An opinion poll showed her to be more than twice as popular as Mr Duceppe.

Ms Marois, a former social worker who served in several top jobs in previous provincial governments, is now in a strong position to lay down the law to the party's troublesome *purs et durs*. Their insistence on an early independence referendum—something most Quebeckers don't want—caused several previous party leaders to resign. Ms Marois says the party needs to stop squabbling over the how and when of a referendum and to focus on why it wants sovereignty in the first place. She does not disavow the party's *raison d'être*, but reckons that the PQ has lost touch with the concerns of many voters.

That much was clear in the election. Action Démocratique du Québec (ADQ), a newish conservative party, usurped the PQ as the official opposition to the ruling Liberals. Some analysts suggest that the ADQ, with its demand for “autonomy” in place of independence, may eventually displace the PQ entirely. The pragmatic Ms Marois seems aware of the danger. Radicalising the PQ “would be a recipe for marginalisation, or even extinction,” she said. Instead she called for a modernised social democracy, with a more efficient state and less regulation. That was Mr Boisclair's message too, but Ms Marois may be a more effective messenger.

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Energy policy in Chile

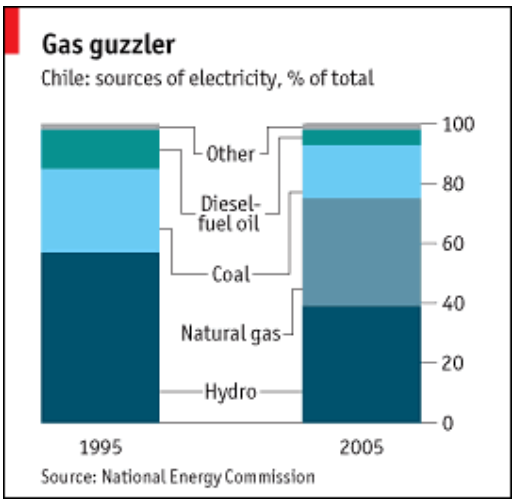
Praying for rain

May 17th 2007 | SANTIAGO
From The Economist print edition

A dash for gas gives way to a proposed return to big dams

Get article background

FOR much of the past two decades, Chile's economy has been the most successful in Latin America. But it has an Achilles heel: energy. Apart from some coal and abundant hydroelectricity, Chile has almost no conventional energy sources. Its neighbours have not proved to be reliable suppliers. The upshot is that, unless the country enjoys a wet southern-hemisphere winter, by next year it could face energy shortages.



Pristine Aysén awaits the pylons

A decade ago Chileans thought they had found the solution: import natural gas from Argentina (see chart). But in the wake of a devaluation in 2002, Argentina's government imposed price controls on gas suppliers. Demand soared, supply fell and two years later the government cut exports to Chile. Further cuts have followed.

According to Marcelo Tokman, Chile's energy minister, Argentina has promised to maintain exports at a level sufficient to cover household use of natural gas in Chile's main cities. If it doesn't, residents may be facing cold showers; plans for a third propane plant in Santiago risk being held up by planning objections.

There is no such promise for industrial users and the electricity industry. What worries officials is what might happen in 2008 if Argentina were to make further cuts in gas exports and if lack of rain cut hydroelectric output. The government is making it easier to install small-scale diesel generators as a stop-gap.

Some of the worries should ease by 2009. By then a terminal for the import of liquefied natural gas (LNG), being built by a consortium headed by Britain's BG Group, is due to start up. But this may not be the answer for the 7,000MW of new generating capacity that Chile needs to keep pace with the estimated growth of demand over the next decade. At current LNG prices, new gas plants would not be profitable unless they were part of a co-generation project that could also sell steam to an industrial client, says Bernardo Larraín of Colbún, an electricity generator.

There is plenty of natural gas in neighbouring Bolivia. That would be especially handy for the big copper mines in Chile's north. But Bolivians still resent Chile's seizure of its coastline in a 19th-century war. Their government refuses to contemplate exporting gas to Chile (though a planned new pipeline from Bolivia to Buenos Aires might allow Argentina to increase exports in the future). So managers at the mines, whose energy costs have risen by up to 50% in two years, are studying coal-fired power plants.

Many energy experts say that more investment in hydroelectricity is the only way to meet future demand. Colbún, in association with Spain's Endesa, is promoting a $2.4 billion project to build four hydroelectric dams, with a total capacity of 2,430MW, in the Aysén region in the far south where rainfall is abundant.

But Aysén is a still-pristine area of fjord and forest. Environmentalists are gearing up to oppose the project. “We can't afford to rule it out without having alternatives,” says Mr Tokman. Rising energy costs shaved at least 0.2 percentage points from economic growth last year, according to the Central Bank. Chile will soon face a conflict between promoting economic growth and protecting the environment.

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Elections in South-East Asia

Voting for more of the same

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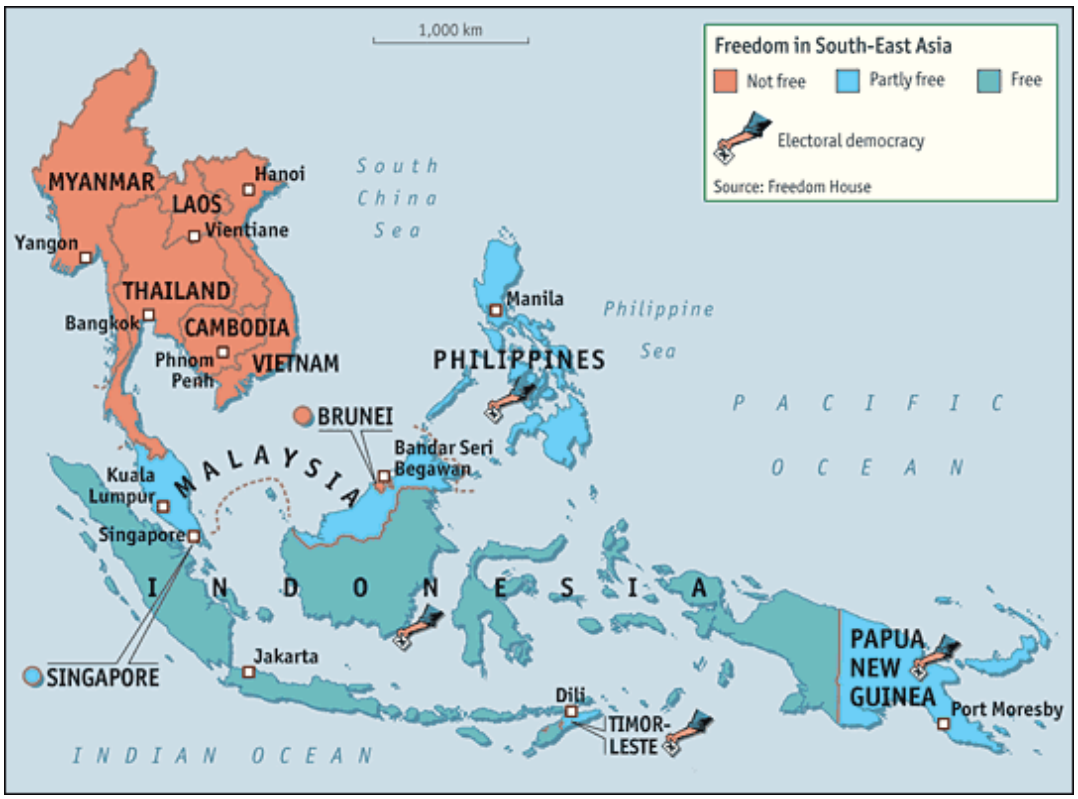
Lots of elections, but democracy remains fragile and limited

SOUTH-EAST ASIA once rode the crest of what Samuel Huntington, an American political scientist, called history's "third wave of democratisation". In 1986, near the wave's peak, a people-power revolt swept away the Marcos regime in the Philippines. In 1992, protests drove Thailand's army out of power. And in 1998, Indonesia's Suharto regime collapsed.

This year, the region has elections galore. On May 14th, Filipinos voted in congressional and local elections. Five days earlier, Timor-Leste's voters chose José Ramos-Horta, once a leading light in the struggle against Indonesian occupation, as its president. On May 20th the Vietnamese will elect a new National Assembly, an institution that has recently become slightly less of a rubber-stamp. Timor-Leste will also elect a new parliament later this year. So will Papua New Guinea. So might Malaysia and, if its timetable for restoring democracy is maintained, Thailand.

Very impressive. But alas, all this voting does not mean that the region's half-billion people enjoy political liberty in its true sense, nor that the freedoms they have come to enjoy are irrevocable.

Until recently, Thailand seemed to be developing towards a liberal, multi-party democracy. Look at it now. The army seized power last September ostensibly to save democracy from Thaksin Shinawatra, an elected strongman. All they seem to have done, so far, is drag the country back to its old cycle of intermittent coups and torn-up constitutions.



Malaysia, Singapore and Cambodia are, nominally, multi-party democracies. But, in each, a long-ruling party or coalition is entrenched. Even excluding hopeless cases like Myanmar, only four countries in the region count as genuine electoral democracies, says Freedom House, an American think-tank (see map). Taking into consideration the broader liberties expected in a true democracy, such as a free press, Indonesia, the group reckons, is the only "free" country.

That may seem harsh. The vigorous campaigning and wide choice of candidates seen in this week's elections make the Philippines appear free. But only last year there was the latest in a string of attempted coups. The need to keep the army sweet has discouraged President Gloria Macapagal Arroyo from ordering proper investigations into hundreds of killings, allegedly by soldiers and police, of opposition figures—from trade unionists to priests. Mrs Arroyo's opponents have been trying to get her impeached since 2004 for allegedly fiddling that year's presidential election. But their failure to coalesce around a credible leader has hindered their progress, both in the impeachment campaign and in this week's election.

Partly as a result, Filipinos' votes are unlikely to change much. Political parties are mostly an incoherent gaggle, which helps the country's traditional political dynasties maintain their grip on power. Despite disappointing early results for Mrs Arroyo (the daughter of a previous president), her allies should keep their big majority in Congress's lower house, while the opposition will still control the Senate.

Academics have been discussing for years whether the third wave of democratisation has passed. If so, perhaps one place to watch out for a future fourth wave is Vietnam. It is developing and urbanising rapidly and its people enjoy increasing economic freedom. The National Assembly and press have recently been allowed to criticise some aspects of government policy. A record 238 independent candidates are standing in this month's elections. Last year, Block 8406, a nascent pro-democracy movement, was formed. If all this were to mark the beginnings of a political opening-up, imagine the possible effects on Vietnam's neighbour, China.

However, Vietnam's Communist Party seems as determined as ever to stomp on challenges to its rule. The National Assembly elections have been preceded by a crackdown on dissidents. On May 15th a trade-union organiser, Tran Quoc Hien, was jailed for five years, essentially for belonging to Block 8406. He was the sixth democracy campaigner to be imprisoned within a week. Yet the government claims, with a straight face, that nobody is jailed for their political views in Vietnam.

Despite self-serving arguments about limited “Asian-style” democracy, peddled for years by ruling elites, and despite setbacks in Thailand and limited progress in Vietnam and the Philippines, there is still no reason why South-East Asia should not become as free as much of eastern Europe has since the third wave washed over it. The largest and smallest countries in the region show that.

In Indonesia, Suharto's Golkar party once seemed unassailable but its candidate came third in the 2004 presidential election. The winner was Susilo Bambang Yudhoyono, a democratically minded ex-general. Some still hanker for the Suharto days but the growth of civil society in Indonesia raises hope that the country can avoid sliding back into authoritarianism.

The success of Timor-Leste's presidential election is another promising sign. The country's descent into violence last year, with its security forces collapsing amid fighting in the streets, caused concerns that the region's youngest country might become a failed state. But the election was mostly peaceful and pretty clean. Significantly, the ruling Fretilin party, whose candidate lost badly to Mr Ramos-Horta, conceded defeat graciously. If things go this well, Timor-Leste may yet develop into a thriving democracy with two main parties—Fretilin and the National Congress for Timorese Reconstruction, recently created by the outgoing president (and Mr Ramos-Horta's ally), Xanana Gusmão. The risk of instability remains. But South-East Asia's youngest nation may yet carry forward the region's hopes for democracy.

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Afghanistan

Death of a Talib

May 17th 2007 | KABUL
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But not of the Taliban

Get article background

A CORPSE with one leg and three bullet holes; few would have been surprised at such an end for Mullah Dadullah Akhund, who was killed by American forces this week in Afghanistan. Like Abu Musab al-Zarqawi in Iraq, to whom he was often compared, the Taliban's most notorious commander mixed extreme rhetoric and brutality with an appetite for publicity.

Reuters

He lived by the sword

Dadullah was revered by his fighters, but was also foolhardy and as careless with the lives of his men as he was thoughtless for his own safety. According to Rahimullah Yusufzai, a Pakistani authority on the Taliban, Dadullah was thought “too big for his shoes” by others in the organisation. Some commanders complained of his enthusiasm for sectarian massacres of Shia civilians and his refusal to listen to orders. Others thought his self-serving videos, with their frequent beheading sequences, were counter-productive or simply “un-Afghan”. He was stripped of his command three times during the Taliban's rise to power.

His death is a blow to the insurgency and a boost to the Afghan government, not least because it is the third strike against the Taliban's old Kandahar-based leadership in the past six months. Of the three closest deputies to Mullah Omar, the Taliban's leader, Dadullah and Mullah Osmani are dead and Mullah Obaidullah is reported to be under arrest by the Pakistani government.

The intriguing question is whether Dadullah's death reveals divisions in the Taliban that might open the way for possible negotiations. There are suggestions he may have been betrayed. Certainly Western commanders are not going to do anything to allay the paranoia over internal security evident in Taliban ranks. American forces were watching Dadullah from the moment he crossed the Pakistani border into Helmand province on May 10th; they killed him within 24 hours.

Dadullah reflected the extreme end of Taliban ideology, one that stresses worldwide *jihad* and the establishment of a new caliphate. This strand of opinion is entwined with al-Qaeda in Pakistan, Iraq, Saudi Arabia and beyond.

Yet hopes that his death may weaken the Taliban and help recent Afghan government overtures for negotiation seem unlikely to be realised. There are precious few signs that moderate voices survive within the upper echelons of the Taliban. And any drop in the insurgency's effectiveness is likely to be short-lived. Others are waiting to flourish Dadullah's Kalashnikovs.

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Central Asia

Stan v stan

May 17th 2007 | ALMATY
From The Economist print edition

A new sort of Great Game

Get article background

CENTRAL ASIA has long been squabbled over by outsiders. The latest manifestation of this old imperial "Great Game" is a proposed gas pipeline linking Kazakhstan and Turkmenistan with Russia (see article). But a struggle for leadership has broken out between countries of the region as well.

When Kazakhstan's president, Nursultan Nazarbayev, proposed what he called a Central Asian union last month, few people paid attention. The Kazakh leader, who was against the break-up of the Soviet Union and is keen on integration European-Union style, periodically floats ideas for a common market. They usually do not get very far because there is little support for them among the neighbours.

At first, there was no reason to think the four other former Soviet republics would like his latest initiative any better than previous ones. But the balance of power in the region is changing. Kazakhstan's oil-fired boom—growth has averaged almost 10% a year since 2000—has imbued the country's leadership with both self-confidence and a sense of mission. Its elite wants to take the impoverished "stans"—Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan—under its wing. Kassym-Zhomart Tokaev, the speaker of the Senate, says that "Kazakhstan is trying to build stability in our region"—a modest claim, perhaps, but one no Kazakh official would have dared to make even a year ago.

The Kyrgyzstanis, who have stumbled from crisis to crisis since their "tulip revolution" in 2005, have been the first to taste Kazakhstan's claims to leadership. During his visit to Kyrgyzstan's capital, Bishkek, at the end of April, the authoritarian Mr Nazarbayev humiliated his counterpart, Kurmanbek Bakiev, by publicly lecturing him about Kyrgyzstan's shortcomings and telling him to follow the Kazakh model: economic reforms before political ones.

President Bakiev was in no position to disagree. Kazakhstan, whose income per person of $3,800 is eight times Kyrgyzstan's, is the country's largest foreign investor. Many successful Kazakh entrepreneurs already think of Kyrgyzstan as pretty much a province of Kazakhstan, anyway. So better bilateral relations are welcome, but a union would be another matter.

All five republics would benefit from closer co-operation, says Sergei Shatalov, the World Bank's country manager in Kazakhstan. All are landlocked. All incur massive transaction costs. All would benefit if they jointly tackled problems such as electricity shortages, water distribution, and drug trafficking from Afghanistan.

The smallest states, Kyrgyzstan and Tajikistan, do not have much room for manoeuvre. Turkmenistan, the region's other big energy producer, used to be isolated by the erratic and megalomaniac leadership of Saparmurat Niyazov. It is possible it might emerge from its shell under a new president, Gurbanguli Berdymukhammedov, who was elected in February—though there is no sign of that yet. So Uzbekistan is the main stumbling block to a Central Asian union.

The Uzbeks, who make up around half of Central Asia's 55m people, see themselves as the region's natural and historic leaders (though there is nothing to back up this claim today). They detest the idea that Kazakhs, whom they disdain as mere nomads, should usurp their role. The repressive Uzbek leadership does not get along with either Tajikistan or Turkmenistan, and relations with Kyrgyzstan fluctuate. Some members of the government grumble they have been too busy defending Central Asia from Islamic extremists to deal with their economy the way Kazakhs have—ignoring the contribution that their own persecution of dissenters has had in encouraging fundamentalism.

In spite of obstacles, the Kazakh authorities remain upbeat about regional integration, and about their own growing clout. But, as one observer in Uzbekistan noted wryly, if Mr Nazarbayev had been really

serious about his proposal, he needed to have made it in the Uzbek capital, Tashkent, alongside President Islam Karimov.

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Japan's ultra-nationalists

Old habits die hard

May 17th 2007 | TOKYO
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Competition for Japan's far right from an unexpected source

Japan's politics

AT SATURDAY lunchtime, Mitsuhiro Kimura can be found outside the east entrance to Shinjuku station, the world's busiest, shouting from atop a van festooned with slogans (Come On Japanese, Stand Up!). Through the van's powerful sound system, he upbraids the area's trendy young with the anti-communist, anti-American, ultra-nationalist message of Issuikai, a prominent *uyoku dantai*, or right-wing group. All very satisfying, no doubt, but off-duty a mild-mannered Mr Kimura, a fixture of chat shows and opinion pages, admits to problems.

The most obvious is that Issuikai, which seeks to persuade people through sweet reason that Japan should unashamedly embrace its imperial past, is rather too easily confused with the blaring vans of more thuggish groups cruising Tokyo's streets. These right-wing gangs are fronts for criminal *yakuza*, Japan's mafia. Of the 900-odd *uyoku dantai* with a total of 10,000 members monitored by Japan's National Police Agency, more than half are fronts for criminal groups. Mr Kimura cannot be persuaded to dissociate himself entirely from such thugs. He notes that both groups will die for a higher power, whether nation or boss. But he acknowledges that ordinary Japanese worry about a rise in political violence and do not distinguish between the groups when apportioning blame.

Last summer the family home of Koichi Kato, a prominent liberal politician, was burnt down by a far-right-winger because Mr Kato had criticised the then prime minister for visiting Yasukuni, Tokyo's controversial war shrine. Last month the mayor of Nagasaki, Itcho Ito—a man of left-leaning views—was gunned down by a prominent *yakuza* in broad daylight while out campaigning. Shinzo Abe, the prime minister, called Mr Ito's assassination a “threat to democracy”.

How times change. It was Mr Abe's own grandfather, Nobusuke Kishi, who as prime minister cemented ties between the government, the *uyoku dantai* and the mob back in 1960, when he enlisted *yakuza* help against left-wing opponents of Japan's alliance with America. Before a planned visit by President Eisenhower, he had summoned some 38,000 heavies to protect the presidential motorcade before the visit was called off.

Yet today Mr Abe's warning is exaggerated. Mr Ito's murder hints at *yakuza* desperation more than strength. The assassin belonged to the local Nagasaki branch of Japan's largest crime syndicate. The branch, which is called Suishinkai, specialised in construction graft on public contracts. But with central and local governments cutting spending, and with a crackdown on public corruption, there is less money to go around. After the shooting, a contrite head of Suishinkai went to the police to say the group was disbanding.

So perhaps the real problem for groups like Mr Kimura's is not confusion with criminals but competition from mainstream politicians. Though beset by myriad disagreements, *uyoku dantai* have long defined themselves by their adherence to a few central tenets. They oppose communism. They want to renounce the pacifist constitution foisted on Japan by America. They want to build up the armed forces and imbue Japan's limp-wristed young people with a greater sense of patriotism.

These views no longer cause shock. Indeed, the government has adopted them. At Mr Abe's urging, a new education law passed in December requires schools to teach pupils about patriotism. The prime minister has upgraded the former defence agency to a ministry, with a seat in cabinet at last. And this week Japan's Diet (parliament) passed a law outlining how a referendum might take place on amending the constitution. If the establishment carries on like this, the *uyoku dantai* will be in as much trouble as the *yakuza*.

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Ideology in China

Confucius makes a comeback

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From The Economist print edition

You can't keep a good sage down

Get article background

“STUDY the past”, Confucius said, “if you would define the future.” Now he himself has become the object of that study.

Eyevine

He championed ancestor worship

Confucius was revered—indeed worshipped—in China for more than 2,000 years. But neither the Communist Party, nor the 20th century itself, has been kind to the sage. Modern China saw the end of the imperial civil-service examinations he inspired, the end of the imperial regime itself and the repudiation of the classical Chinese in which he wrote. Harsher still, during the Cultural Revolution Confucius and his followers were derided and humiliated by Mao Zedong in his zeal to build a “new China”.

Now, Professor Kang Xiaoguang, an outspoken scholar at Beijing's Renmin University, argues that Confucianism should become China's state religion. Such proposals bring Confucius's rehabilitation into the open. It is another sign of the struggle within China for an alternative ideological underpinning to Communist Party rule in a country where enthusiasm for communism waned long ago and where, officials and social critics fret, anything goes if money is to be made.

Confucius's rehabilitation has been slow. Explicit attacks on him ended as long ago as 1976, when Mao died, but it is only now that his popularity has really started rising. On topics ranging from political philosophy to personal ethics, old Confucian ideas are gaining new currency.

With a recent book and television series on the Analects, the best-known collection of the sage's musings, Yu Dan has tried to make the teachings accessible to ordinary Chinese. Scholars have accused her of oversimplifying, but her treatment has clearly struck a chord: her book has sold nearly 4m copies, an enormous number even in China.

Further interest is evinced by the Confucian study programmes springing up all over the Chinese education system. These include kindergarten classes in which children recite the classics, Confucian programmes in philosophy departments at universities, and even Confucian-themed executive-education programmes offering sage guidance for business people.

But perhaps the most intriguing—albeit ambivalent—adopter of Confucianism is the Communist Party itself. Since becoming China's top leader in 2002, President Hu Jintao has promoted a succession of official

slogans, including “Harmonious Society” and “*Xiaokang Shehui*” (“a moderately well off society”), which have Confucian undertones. On the other hand, says one scholar at the party's top think-tank, the Central Party School, official approval is tempered by suspicions about religion and by lingering concern over the mixture of Buddhism and other religious elements in Confucian thinking.

The relevance of Confucian ideas to modern China is obvious. Confucianism emphasises order, balance and harmony. It teaches respect for authority and concern for others.

For ordinary Chinese, such ideas must seem like an antidote to the downside of growth, such as widening regional disparities, wealth differentials, corruption and rising social tension. For the government, too, Confucianism seems like a blessing. The party is struggling to maintain its authority without much ideological underpinning (Deng Xiaoping questioned the utility of ideology itself when he said that it doesn't matter if a cat is black or white so long as it catches mice). Confucianism seems to provide a ready-made ideology that teaches people to accept their place and does not challenge party rule.

As an additional advantage, Confucianism is home-grown, unlike communism. It even provides the party with a tool for advancing soft power abroad. By calling China's overseas cultural and linguistic study centres “Confucius Institutes”, the party can present itself as something more than just an ideologically bankrupt administrator of the world's workshop.

Yet despite this, Confucianism is not an easy fit for the party. It says those at the top must prove their worthiness to rule. This means Confucianism does not really address one of the government's main worries, that while all will be well so long as China continues to prosper, the party has little to fall back upon if growth falters.

Writing last year, Professor Kang argued that a marriage of Confucianism and communism could nevertheless be made to work. He argued that the party has in reality allied itself with China's urban elite. “It is”, he wrote, “an alliance whereby the elites collude to pillage the masses,” leading to “political corruption, social inequality, financial risks, rampant evil forces, and moral degeneration.” The solution, he argued, was to “Confucianise the Chinese Communist Party at the top and society at the lower level.”

But Stephen Angle, a Fulbright scholar at Peking University and a philosophy professor at Wesleyan University in America, argues that Confucianism may not be as useful to the party as it thinks. For a start it has little to say about one of the party's biggest worries, the tension in urban-rural relations. More important, a gap in Confucian political theory should alarm a government seeking to hold on to power in a fast-changing environment. “One big problem with Confucianism”, says Mr Angle, “is that it offers no good model for political transition, except revolution.”

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Zimbabwe

Back to the dark ages

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From The Economist print edition

Peter Schrank

The last person to leave may not have any lights to turn out

Get article background

IT IS hard to imagine that things could get any worse in Zimbabwe. But, sure enough, day by day, they do. Since the opposition, NGOs and church groups organised a protest rally that was brutally crushed in March, the police and militias have been intimidating, arresting and beating up political opponents, journalists, lawyers and ordinary people alike. The government has even warned the Catholic bishops, once considered inviolate, to shut up or suffer the same fate. Meanwhile the inflation rate has passed 2,200%; last week the national power company announced that it would ration electricity in cities, possibly to a meagre four hours a day, just as the southern hemisphere's winter is starting to bite.

Power cuts are already frequent, but the latest blackouts mark a new low. Residents of Harare, the capital, have been rushing to get firewood and paraffin, though a domestic worker's monthly wage can buy only five litres (1.3 American gallons) of paraffin or two litres of cooking oil. Many companies, already operating at about 40% of capacity, say the cuts will force them to reduce their working hours even more. “The whole thing is a nightmare,” says Lovemore Mandebvu, who runs a small furniture-making factory in Harare. “We don't know when we will have power and when it goes. This is affecting our output. Then at home water runs out when you are bathing, and the electricity goes while you are cooking.” Hospitals must use gas stoves, coal-fired boilers, fuel generators, solar power and candles.

Basic staples like maize are becoming harder to buy. The official rate for the Zimbabwe dollar is 250 to the American one, but the street value is now closer to 32,000. Many Zimbabweans survive only thanks to the 3m or so friends and relatives who have emigrated. Every day desperate Zimbabweans cross the Limpopo river, braving crocodiles and occasionally drowning, to try their luck in neighbouring South Africa. Trapped into illegality there, many are exploited and abused.

Those who stay face the increasingly arbitrary power of the police and militias. Since the crackdown in March, there have been raids on Harare districts such as Highfield and Glenview, known opposition strongholds, where random beatings and arrests have become common. President Robert Mugabe's government claims that the opposition Movement for Democratic Change (MDC) is responsible for the violence and is behind a wave of bombings. The MDC says the bombs are planted by the police to justify repression. Last week lawyers protested against the arrest of two colleagues and the routine defiance of court orders by the police. A march was dispersed and several lawyers assaulted.

The latest efforts of Zimbabwe's neighbours to improve things are still going nowhere. After the violence in March, the Southern African Development Community, a regional club of 14 countries, mandated

South Africa's president, Thabo Mbeki, to encourage negotiations between Mr Mugabe and his opponents. But the International Crisis Group, a Brussels-based think-tank, says that Zimbabwe's ruler has shown no willingness to co-operate with the regional initiative to prepare the ground for presidential and parliamentary elections due next year, when Mr Mugabe looks likely to run again. At present, there is little chance the elections will be fair.

But some of Zimbabwe's neighbours are sounding exasperated. Last week the Pan-African Parliament, a talking-shop with a secretariat in South Africa, said it would send a mission to investigate human-rights abuses. Mozambique's energy company, a big supplier of Zimbabwe's electricity, may switch off power unless it gets paid. And South Africa's government, long in denial about the crisis on its doorstep, has just granted political asylum to Roy Bennett, the MDC treasurer who fled Zimbabwe to avoid another arrest. It turned down his application last year.

Still, this rare build-up of pressure was released last week when, to the dismay of the United States, the European Union and many others, Zimbabwe's minister of environment and tourism, Francis Nhema, was elected to chair the UN Commission on Sustainable Development, where he will preside over discussions on land and rural development. Astonishingly, the UN's African members, whose turn it was to hold the rotating post, could think of no better candidate than one from a country whose agriculture has been largely destroyed by its government's catastrophic policies. Like many other Zimbabwean bigwigs, Mr Nhema himself pocketed a farm that was confiscated a few years ago—and has already let it lapse into ruin.

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Africa and China

The host with the most

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Where do Africa's top bankers have a meeting? Shanghai, of course

LIKE another international bank, safely ensconced in Washington, DC, the African Development Bank (AfDB) has shared some of the indignities its borrowers suffer. In 1995, it endured a financial crisis, losing its top-notch credit rating (since restored). And in 2003, it became a refugee, fleeing its home in war-torn Côte d'Ivoire to huddle temporarily in Tunisia.

Like many of its 53 African members, the bank now shares a fascination with China. Not surprising, perhaps, as China has become one of Africa's most intrepid investors, sinking almost $12 billion into the continent, and biggest customers, buying over a tenth of sub-Saharan Africa's exports ($19.2 billion) in 2005. This week the bank held its annual meeting in Shanghai, accompanied by legions of ministers, central bankers and businessmen. China, with its stunning economic success, has inspired the bank, said Donald Kaberuka, the AfDB's president.

But it is also a rival. The AfDB approved $3.4 billion of loans last year. But China's official Export-Import bank (China ExIm) has become a big presence in Africa too. Counting media reports alone, its loans topped $7 billion in 2004-06, albeit on more commercial terms, according to the Centre for Global Development, a Washington think-tank.

The AfDB and China ExIm also want to do similar things, financing the dams, roads and power lines neglected by Western donors, who tend to favour hospitals and schools. The AfDB's lending for infrastructure grew by almost a quarter last year; water, transport and power accounted for a third of its money. This month, for example, the bank approved a loan of $110m to help build a hydro-electric dam on Uganda's White Nile. Meanwhile, China has reportedly provided $2.3 billion to Mozambique for another hydro-electric dam on the Zambezi.

Chinese competition may spur the AfDB to reform its cumbersome procedures, though some worry that it will undercut the bank's attempts to enforce such niceties as environmental rules. More galling for other foreign lenders is what they see as China's free-riding. Some African governments can afford fresh loans from China only because the AfDB, the IMF and the World Bank recently forgave their sour ones. The AfDB has forgiven over $5 billion of debt since 1998.

The World Bank and the IMF hope that all creditors will abide by a system of “traffic lights”. Relatively well-run, lightly indebted countries like Tanzania and Mozambique have a “green light” to take on more debt, even on commercial terms. But other countries, with less financial nous and more debt, face red.

China, however, seems willing to jump the lights. For example, it lent $800m to Sudan in 2005 and a similar amount last year—as Sudan queued up to have its multilateral debts written off.

This week, Mr Kaberuka urged African countries to manage their debts sensibly. It is not clear whether his borrowers or his host would listen. His bank is still looking for a permanent home, as well as a more clearly defined role of its own. But this week's jamboree suggests the true headquarters of African development may be moving east.

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Kenya

Bring back hunting?

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An argument over what to do with wildlife has been revived

FROM a red hill in Hell's Gate National Park, an hour's drive north-west of Kenya's capital, Nairobi, you can see zebra, giraffe and buffalo grazing in the valley below. Flower farms on the edge of Lake Naivasha, growing roses for Europe, begin at the park gates. Beyond are fenced-in ranches. Lions still occasionally prowl nearby, but their numbers are dropping. There are no elephants any more. Wild animals are often killed illegally for bush meat. The shacks by the flower farms sell impala meat to the hard-pressed workers.

In Hell's Gate and across Kenya, wildlife is under threat as the frontier for development expands. Kenya may have lost one-third or more of its wildlife in the past 20 years, in contrast to southern Africa, where wildlife has bounced back with the creation of private game reserves and with state-controlled hunting.

Kenyans have been arguing over a possible change in the law to allow “sustainable use” of wildlife on private land. Animal-welfare groups call that a euphemism for trophy hunting, which Kenya banned in 1977. Such groups are influential, not least for their gifts of equipment to the cash-strapped Kenya Wildlife Service (KWS), which runs Kenya's game reserves and parks. They oppose in principle the commercial exploitation of wild animals and vilify “canned hunting” in southern Africa, where lions and other game that is sometimes baited and even drugged have been lured into the sights of a rifle.

The animal-rights people miss the point, say their market-minded foes, who argue that wild animals need an economic value to survive the intense demands of economic and population growth; hunting under licence can bring in much-needed revenue without threatening the survival of any species. Gazelles, if well managed for meat, can be worth more than cattle. The marketeers detest the emotive campaigns of animal-rights groups, such as Born Free and the International Fund for Animal Welfare, which they accuse of disinformation. Pro-hunting campaigners say that antelope and buffalo would be the main quarry. Elephants would definitely be excluded; poaching of them has begun to increase again, especially as China, which loves ivory, gets richer. Hunting on private ranches in the vast parts of Kenya where few tourists now venture would, say pro-hunters, secure biodiversity at no cost to the taxpayer.

Trophy-hunting schemes have worked in less populated bits of Namibia and Zimbabwe, but some doubt they would work in Kenya. Richard Leakey, a former KWS head who is one of Kenya's doughtiest campaigners for cleaner politics, is not against hunting in principle. “Market forces are essential for the long-term survival of species,” he says. But he wonders how such forces could be controlled in Kenya, where public services are ropey and corruption rife. Who, for instance, would regulate a trade in bush meat?

Moreover, the argument arouses fierce political passions. Unless income from hunting is effectively distributed to locals, through local councils that have often squandered or filched their receipts from other types of tourism, populist politicians will castigate hunting, if it is brought back, as a return to “white man's Africa”.

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Palestine

Gunning in Gaza

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The Palestinian unity government is failing in its first task

EPA

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THIS week's fighting in the Gaza Strip between gunmen of the two main rival Palestinian groups, Fatah and Hamas, has so far taken at least 40 lives. The worst violence since the two parties formed a unity government in March, it seemed to prove that their coalition's first big goal—to stop such fighting as a step towards re-engaging with Israel and the world—is unattainable.

This was pretty much expected. The last sticking-point in the two parties' talks was whom to put in charge of the bloated security services. Over the years these have acted as an employment sponge for veterans of the militias fighting against the Israeli occupation of the West Bank and Gaza, the two bits of a fledgling Palestinian state. The secular Fatah, which ran the Palestinian Authority (PA) for the first 13 years of the authority's existence, dominates the security forces in the West Bank. But in Gaza the Islamists of Hamas, who took over the PA after winning an election last year, have brought several thousand of their militants into an “Executive Force” under the PA's umbrella. On top of that, Gaza's large clans and criminal gangs wield their own powerful militias.

Hani Qawasmeh, the man eventually chosen as interior minister, drew up a plan for co-ordination between security chiefs as well as clan leaders. But as a bureaucrat with no power base of his own, he met resistance from both sides. In particular, he complained that he was being undermined by his underling, Rashid Abu Shbak, who in practice is loyal to Muhammad Dahlan, a Fatah strongman in Gaza. On May 10th, Mr Abu Shbak ordered Fatah forces onto the streets of Gaza without Hamas's agreement or Mr Qawasmeh's say-so. Some Hamas gunmen, seeing themselves sidelined, opened fire on them.

That escalated into this week's carnage. So far Hamas has bested Fatah, though the Executive Force at first stayed out and left the job to Hamas's own militia. Among its victories was to destroy Mr Abu Shbak's home and kill six of his bodyguards.

Moreover, the militia scored some unusually accurate hits on Israel; its improvised rockets, known as Qassams, which usually land harmlessly on empty territory, this week injured at least 20 people. Israel, desperate not to let Hamas distract Gazans' attention from their own internal troubles, restricted itself to an air strike on a Hamas base, killing four militants.

Mr Qawasmeh, who had tried to resign several weeks before, has now quit for good. Hamas's Ismail Haniyeh, the prime minister, took over. But he can at best cool things down for a while. Fatah is divided over whether to back the unity government. Mr Dahlan, in the no camp, is biding his time until Fatah is strong enough to challenge Hamas in Gaza; Mr Abu Shbak's provocation may have been an ill-advised test of force. A similar split bedevils Hamas; its anti-unity hardliners were left out of the coalition and have been suspected of stoking violent incidents in the past.

But as well as ducking bullets from Hamas-Fatah battles and clan feuds, in the past few months Gazans have suffered a rise in attacks of a more mysterious and sinister nature. Dozens of internet cafés, video shops and other establishments for the secular-minded have been bombed. Often the perpetrators claim to espouse fundamentalist Islam or even al-Qaeda-style *jihad*, hitherto generally alien to the Palestinians. One such group, the Army of Islam, recently claimed to be holding the BBC's Gaza correspondent, Alan Johnston, who was kidnapped in March. If al-Qaeda did take advantage of the chaos to gain a foothold, it would put a frightening new complexion on the conflict.

Most think the Army of Islam is just a front for a criminal gang; that may apply to many of the bombings too. But it all adds to the sense that Gaza is beyond the PA's control. If the Palestinian unity government crumbles and Israel can hold back from a massive military operation, it could open an opportunity for Mr Dahlan, who has been quietly restoring his political influence after a period out in the cold, to make a new bid for increased power. Hamas hates Mr Dahlan; but some security-minded Israelis think he is a man they can do business with.

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Iran, Iraq and the United States

Neighbourly mumblings

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Will the United States and Iran really start talking, if only about Iraq?

Get article background

IT SEEMS increasingly likely, after 28 years of formal silence (with just the occasional back-channel mutterings and whispers), that American and Iranian officials will sit down together, if only to talk about Iraq. The two sides are expected to meet, perhaps only at ambassadorial level to begin with, on May 28th in Baghdad. However big the caveats, it will be a breakthrough. Each side is keen to assert it has not flip-flopped. Neither side is sure where such talks might lead.

In fact, the Americans have been saying for some time they would talk to Iran—but only about Iraq, not about the Islamic Republic's nuclear plans, so long as the Iranians refuse to suspend their enrichment of uranium. The rulers in Tehran have also occasionally expressed a readiness to engage in such talks. But whenever the prospect has loomed large they have backed off. Now, it seems, the Iranians—at least, some parts of its fractious establishment—are becoming keener. Some members of Iran's parliament have even begun collecting signatures to form an Iranian-American friendship committee.

The American establishment has been fractious too. The vice-president, Dick Cheney, sounded as tough towards Iran as ever during a trip to the Gulf states last week. But the State Department, under Condoleezza Rice, is plainly becoming more flexible. Robert Gates, the newish secretary of defence, seems to have swung the Pentagon's weight behind Ms Rice.

The latest diplomatic surge gained momentum earlier this month at an international conference on Iraq in the Egyptian resort of Sharm el-Sheikh. The Egyptian hosts seated Iran's foreign minister, Manouchehr Mottaki, opposite Ms Rice, at a dinner, in the hope that the pair might exchange a word or two. But the Iranian walked out in a huff, complaining later that the event failed to meet “Islamic standards”, an apparent reference to a female Ukrainian violinist who was wearing a supposedly immodest scarlet dress. Other diplomats present thought he may have disliked being bounced unceremoniously into a high-level summit.

But this week things moved on. Iran's president, Mahmoud Ahmadinejad, said his government was “prepared and ready” to talk to America, while insisting that their troops should “pack their bags” and leave Iraq and the Gulf region forthwith.

It will still be hard to agree, beforehand, on the agenda, even with nuclear issues kept off it. The Iranians would be loth to discuss an issue that particularly grates with the Americans: the help Iran apparently gives to Iraqi Shia militias who plant roadside bombs that kill American troops.

And it will be hard to detach the question of Iraq completely from the Iranian nuclear one. Iran keeps its links with Iraq's Shia militias so that, if America were to bomb Iran's nuclear facilities, Iran would be able to make things even nastier for America in Iraq. It is highly unlikely that America would be able to persuade Iran to break those links altogether.

Iran does have pressing if lesser grievances that could be more easily dealt with if the two sides did meet. One concerns five Iranians in Iraq who the Iranian government insists are diplomats but whom the Americans accuse of helping to arm Iraqi militants—and therefore arrested, in the Kurdish capital, Arbil.

Iran has also long wanted the Americans to acknowledge that it has its own legitimate security interests in the region, some of them in Iraq. And if Iran and America were ever to come to a “grand bargain” that did include the nuclear issue, Iran would also expect America to disavow any intention of promoting regime change in Tehran and to stop helping opposition groups. That prospect is far off.

Meanwhile, the Americans are still struggling to enlist the help of other nearby countries to stabilise Iraq, where the war is as bloody as ever. At Sharm el-Sheikh, they had hoped to get firmer promises from countries such as Saudi Arabia and Kuwait to forgive the $50 billion or so of debt that Iraq estimates it owes; only vague noises were forthcoming. The Saudis say that, before they start being generous, the Iraqi government should try harder to accommodate Iraq's Sunni Arabs. And Russia first wants Iraq to recognise a Saddam-era oil contract.

Yet the Sharm el-Sheikh meeting was a bit more fruitful than other attempts to get the outside world to help Iraq. The Saudis, for example, have more or less admitted that the new political order, led by Iraq's Shias, is there to stay. And American diplomats say they had a useful talk with the Syrians. As Syria seems to be edging out of its isolation in the region, it may—to please the Americans—be prepared to do more to stem the flow of people and munitions across the border to insurgents in Iraq.

A new factor is that Iraq's neighbours guess that America is increasingly likely to leave Iraq within the next two years, especially if a Democratic president takes office. That prospect is beginning to concentrate Arab minds. Some fear that Iraq's sectarian mayhem could spread dangerously beyond its borders. Most of Iraq's nervous Arab neighbours do not want a bloody American-Iranian bust-up.

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Iraq and the Kurds

A truly national army?

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Iraq's Kurdish soldiers have been welcomed in parts of Baghdad

AFP

A Kurd with an Iraqi flag

Get article background

BRISTLING with weapons, the men arrived on the back of three pick-up trucks, then surrounded the modest house in the once "mixed" suburb of al-Amel, in western Baghdad. A black-clad gunman jumped down and hammered on the thin metal gate. There were "bad people" on the loose, he shouted to the residents cowering inside. They should pack up and go and live "among your own people—for your own protection". He and his men would helpfully put their belongings on the back of the trucks. For safety's sake, the family should go immediately. As this ultimatum was being given to the terrified Sunni Arab family by the Shia gunmen, a group of Iraqi policemen, also Shias, leant on a police car and idly puffed away on their cigarettes, just 50 yards up the street, indifferent to the crime of sectarian cleansing being perpetrated under their noses.

That scene has become all too common in al-Amel—and in many other mixed districts. Since the bombing of the Shias' shrine in Samarra, north of Baghdad, in February last year, many mixed and middle-class areas have become either mostly Shia or mostly Sunni, depending on which side of the main road you live.

Yet on the occasion described above the Sunni family managed to sit tight, in the house they had built some 30 years ago in what was then a palm grove. They were saved by the arrival, in the nick of time, of a contingent of about 100 Kurdish soldiers, some of the 3,000-odd former *peshmerga* fighters (literally, "those who face death") who have joined Iraq's national army and have been controversially deployed in Baghdad as part of the "surge" of troops, mainly American ones, to beef up security in the bloody capital.

As they neared the besieged house, the Kurdish soldiers shot over the heads of the Shia gunmen, identified by locals as members of the Mahdi militia loyal to a Shia firebrand, Muqtada al-Sadr, and told them to leave the area. They swiftly complied. There was no American soldier in sight.

It is still too soon to say, three months after the surge began, whether it is working. Only about half the promised extra 22,000-plus American troops earmarked for Baghdad have arrived. Sectarian murders, mainly of Sunnis by Shia militias, are fewer; but bombings, including suicide ones, by Sunni- and al-Qaeda-linked insurgents, are more frequent. The overall death toll is down a bit but is still horrific.

But in the mixed areas of the capital where Kurdish troops incorporated into the national army have been deployed, residents and American officers notice a definite drop in sectarian cleansing and violence. People's confidence in the security forces, they say, has improved. In al-Amel more shops are opening up again; a semblance of normal daily life has resumed. Some expelled Sunni and Shia families, though still just a trickle, have returned.

"The Kurds are welcomed here by the people," says a Sunni Arab in al-Amel. "They want to restore order. They are more polite than the Americans and not as dangerous as the Shia militias." General Nazir Goran, a Kurd who commands an Iraqi army brigade in the capital, says that his men have been operating effectively in some of the capital's "hot zones", mainly in western Baghdad. But they still feel obliged to avoid the areas of eastern Baghdad controlled by the Sadrists.

In any case, the first loyalty of the Kurds inducted into the national army is to their Kurdish homeland and its regional government, not to the Iraqi state. Iraqis of all stripes generally reckon that the Iraqi

army is less under the influence of Shia groups than are the police, which have been heavily infiltrated by Shia militiamen. Most army recruits are Shias and Kurds; less than a tenth of the officers are Sunnis.

The decision to send Kurdish units of the Iraqi army to Baghdad was controversial in Kurdistan. Many Kurds worry that the deployment will drag them into the sectarian conflict between Sunni and Shia Arabs. Other Kurds say, “It's not our battle.” But so far they have been welcomed by a surprising number of Iraqi Arabs, even though they have often viewed the Kurds as a threat to Iraq's fragile unity.

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Russia and the West

The big chill

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Peter Schrank

America and Europe confront a new freeze in their relationship with Russia

AMERICA'S security is “threatened less by Russia's strength than by its weakness and incoherence,” wrote Condoleezza Rice, now America's secretary of state, in 2000, shortly before Vladimir Putin and George Bush were elevated to their countries' presidencies. The Russia that Ms Rice visited this week sees itself differently. It feels economically strong, assertive and more coherent—at least in its anti-Americanism.

Russia has learned to use its vast natural resources to exert power in Europe and beyond. This week, just ahead of a testy bilateral summit with the European Union in Samara, its clout was enhanced by Mr Putin's crude but effective diplomacy in Central Asia. He persuaded Kazakhstan and Turkmenistan to send more gas exports through Russia, spoiling the rival plans of America and Europe for a trans-Caspian pipeline that would skirt south of Russia. Ms Rice's comment that “no one needs a monopoly” in natural resources will merely bring smiles to the faces of Kremlin officials.

Just before Ms Rice's visit, the Kremlin's rumbustious anti-American rhetoric hit new peaks. In his speech on Victory Day (May 9th), Mr Putin seemed to liken America to the Third Reich. “The victory once again will be ours,” Russia's state television channel echoed. This week Ms Rice and Mr Putin agreed to tone down such verbal hostilities. But they made no progress on wider disputes.

One difference between the two sides is how much they matter to each other. To Russians, America is a yardstick of their own place in the world. To Americans, Russia is just one factor in its foreign policy—and not the biggest one. Few things give Russians as much sense of their own importance as a spat with America. “They like to counter America. It makes them feel good,” says one senior American official.

Russia's self-esteem has long been inseparable from its relationship with America. To have America as an enemy in the cold war gave the Soviet Union a sense of urgency and purpose. The end of the cold war deprived Russia of a vital adversary. It is only logical that Russia should now demonstrate its resurgence by sparring with America again. America's troubles in Iraq make this an apt moment for Russia to return to the world stage.

“America is a crucial part of Russian domestic life and its self-consciousness,” says Lilia Shevtsova of the Carnegie Moscow Centre. “America consolidates Russia's elite and prolongs its existence.” But America has a big place in popular imagination too. Lev Gudkov, a sociologist, says the view of America as rival is inseparable from the perception that it is a country of wealth and happiness: a Utopia. (“Tell them I've gone to America,” says a character in Dostoevsky's “Crime and Punishment”, before putting a gun to his head.)

America has no equivalent neurosis. Russia matters, but much less than in the cold war. “Then, the American-Soviet relationship defined everything else. Now, everything else defines the relationship with Russia,” says a Russia analyst in Washington, DC. As a veto-wielding member of the UN Security Council, Russia can block resolutions on Kosovo's independence or Iranian sanctions. But as Richard Haass, head of the Council on Foreign Relations (CFR), says, “Russia has failed to articulate a positive strategy. Oil allows it to be a spoiler, but it is unclear what it stands to gain from it.” A CFR report concludes that a strategic partnership between Russia and America “no longer seems realistic”.

This is a big shift from Bill Clinton's hopes of integrating Russia into the West in the same way as America did for Germany and Japan after the war. “Clinton believed that America cannot be secure without a democratic Russia,” says Ms Shevtsova. Yet America's help in transforming Russia into a free-market economy in the 1990s is at the root of much Russian anti-Americanism, as America was blamed for the transition's failings. “The Clinton administration's embrace of Yeltsin and those who were thought to be reformers around him has failed,” Ms Rice argued in 2000. Mr Putin too sees the 1990s as a wasted decade and has spent the seven years since reversing much of the Yeltsin legacy, including on privatisations and freedom of speech.

The failures in the 1990s were not the only thing on which Mr Bush and Mr Putin agreed. The high point in their relationship came after September 11th 2001. Mr Putin was the first leader to call Mr Bush and offer support: “a master-stroke of diplomacy”, says Mark Medish, vice-president of the Carnegie Endowment in Washington. Russia helped America to gain access to Central Asian states and provided helpful intelligence in the early months of the war in Afghanistan. “The Russians were among the few who had operational information on the ground,” Mr Medish says.

That co-operation led to two misjudgments. The White House felt that Russia's support meant there was a “strategic partnership” based on similar values; the Kremlin believed America would reward it. Inevitably, both sides now feel disappointed. Mr Putin thinks he got nothing out of his westward swing. Some of his grievances are legitimate, say former and present members of the American government. “We used Russian intelligence in Afghanistan, but did not want to let them too close to what we were doing,” says a former top official. Russia is still subject to the Jackson-Vanik amendment that penalises countries with non-market economies and restrictions on emigration. “It clearly does not apply to Russia. But Bush did not put any of his political capital into getting it lifted,” the ex-official adds.

But the main reason for the rift is Russia's behaviour abroad and at home: its arms sales to Iran and Syria, its links with Myanmar, its political use of energy, its harassment of the opposition and non-governmental organisations and its use of law as a repressive tool. The toning down of language that Ms Rice and Mr Putin want only masks these deeper problems.

The danger is not that Russia will prevent the independence of Kosovo or the placement of American missile defences in eastern Europe (both will go ahead, whether Russia likes it or not, Ms Rice said in Moscow). Nor is it that Russia will pull out of arms-reduction treaties. The bigger fall-out will be in Russia itself. Hatred of America gives cover for growing authoritarianism, nationalism and concentration of money and power in the hands of former and present members of the security services. If this continues, Ms Rice's successor may need to review what constitutes the real threat to America's security.

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France's new president

An inclusive government

May 17th 2007 | PARIS
From The Economist print edition

President Nicolas Sarkozy picks a surprising Socialist as foreign minister

Get article background

THE polished brass hats, shiny trumpets and 21-gun salute that marked the investiture of Nicolas Sarkozy as president in place of Jacques Chirac on May 16th were all part of the traditional ceremonial pomp at the Elysée. Yet the new President Sarkozy promptly set out to deliver his promised break with the past, flying to Berlin the same day. Two days later he was expected to pick a broad-based government.

To no surprise, his prime minister will be François Fillon, a Gaullist former social-affairs minister who pushed through a mini-reform of state pensions in 2004. A late convert to the Sarkosphere, he has become a loyal right-hand man and foil to the hyperactive Mr Sarkozy, tough enough to push reforms but not so strong as to overshadow what will be a hands-on presidency.

Mr Sarkozy's *coup de théâtre* was his expected choice as foreign minister: Bernard Kouchner, a man of the left. This will not only upset the Socialists, who are muttering about treason, but also secure one of France's most popular political personalities, as well as showing Mr Sarkozy's inclusiveness. Mr Kouchner's humanitarian background, as co-founder of Médecins sans Frontières and UN boss in Kosovo, dovetails neatly with Mr Sarkozy's keenness on a human-rights element in his foreign policy. A pro-European, Mr Kouchner was one of the few Frenchmen to support the invasion of Iraq—though he fiercely criticised American management of the aftermath. He will be complemented by the expected return of Jean-David Levitte, France's ambassador in Washington, DC, to be Mr Sarkozy's American-style national security adviser.

There will be change at the Ministry of Finance as well. It is expected to be split in two, with an economic strategy and jobs portfolio going to Jean-Louis Borloo, outgoing social-cohesion minister, as part of Mr Sarkozy's efforts to convert the French to the idea that growth and jobs are linked and employment is not just a welfare matter. “Work, effort, merit”, a campaign slogan, rang out from Mr Sarkozy's investiture speech. A former prime minister, Alain Juppé, despite a past conviction for political corruption, is likely to have a super-ministry of ecology, energy and transport.

Mr Sarkozy's biggest challenge has been trying to meet his own pledge—made when he faced off with a female rival in Ségolène Royal—to fill half his streamlined cabinet of 15 with women. Christine Lagarde, the outgoing trade minister, and Michèle Alliot-Marie, the departing defence minister, were expected to get top posts, as might Christiane Taubira, a black left-wing deputy. A few centrists are also expected to land jobs. But some of the new president's old (male) friends are set for disappointment. “Loyalty is a matter of sentiment,” said Mr Sarkozy a few days before his investiture. “Efficiency is for government.”

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Germany's grand coalition

A North Sea signal

May 17th 2007 | BERLIN
From The Economist print edition

The Bremen election deals a big setback to Germany's grand coalition

THE election in Bremen will have no impact on federal politics, said Angela Merkel, the German chancellor, after meeting fellow Christian Democrats (of the CDU) on May 14th. The previous day, the Social Democrats (of the SPD) and Greens won enough votes in the city to replace the state's grand coalition, which mirrors the federal one. Jens Böhrnsen, boss of the Bremen SPD, has not yet ended his 12-year tie to the CDU, but he is likely to.

Bremen has been an SPD fief for 60 years. Yet in the latest election, both main parties lost votes. The SPD took 37%, down from 42% four years ago; the CDU fell to 26%, down from 30%. The winners were the three smaller parties in opposition at federal level: the Greens, the Free Democrats and the Left Party, which will enter Bremen's parliament for the first time.

Mr Böhrnsen may end his alliance with the CDU, but Kurt Beck, the SPD chairman, is unlikely to do likewise in Berlin. Mr Beck is less popular than Ms Merkel and his party is in crisis. SPD members are unhappy with his centrist policies and what they see as the party's loss of ideological identity. The Left Party, a mix of disaffected SPD members and ex-communists, attracts nostalgics in SPD heartlands.

The SPD may need a more charismatic leader before the next federal election. But at present there is no alternative. Franz Müntefering, the vice-chancellor and labour minister, and Peter Struck, head of the SPD parliamentary group, are set to leave politics at the end of the grand coalition's term in office. A rumoured comeback by Gerhard Schröder, the former chancellor, seems implausible. Besides, Mr Beck has SPD friends who say he merely needs time to get his party under control—rather as Ms Merkel did, before becoming uncontested leader of the CDU.

The coalition is likely to last at least until next year, when state elections are due in Hamburg, Bavaria, Lower Saxony and Hesse. Doubtless the SPD and the CDU will continue to bicker, as they did this week when their leaders met for inconclusive talks over the planned minimum wage. They did agree to triple the number of nursery places to 750,000 by 2013, and they compromised on the reform of inheritance taxes. This paves the way for a cut in corporate tax, because the SPD had linked its support of this with changes in the tax treatment of inheritance.

In line with the normal German fondness for consensus politics, the leaders of the two big parties will continue to strike deals on most policy decisions. But two possible rows could yet spell an early end to the grand coalition. One would come about if the SPD were to insist on ending the deployment of German troops outside the NATO area. The other would come if the CDU were to seek to abolish Germany's co-determination system, under which big firms draw at least half their supervisory boards from the ranks of the workforce or trade unions.

Ms Merkel is right to say that Bremen is not a barometer of public opinion. The Greens and the SPD would not get enough votes to form a government if a federal election were held today. Rather, the Free Democrats and the CDU might win a majority. That is the last thing the SPD wants—and a measure of Mr Beck's problems.

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Poland's purges

False lustre

May 17th 2007 | WARSAW
From The Economist print edition

The Polish government is all tangled up in the past

Get article background

OUTSIDERS like to decry Poland's ruling twins, sometimes as buffoons, sometimes as bloodthirsty inquisitors. Both characterisations of Lech and Jaroslaw Kaczynski, respectively president and prime minister, are unfair, but each contains a grain of truth. The twins' foreign policy has been inept, sometimes comically so. And, until it was struck down by the constitutional court last week, their vetting law seemed not only sweeping, but downright sinister.

Its aim was to screen 700,000 people for past collaboration with the communist-era secret police, including not only journalists and academics but also some (previously vetted) anti-communist politicians, such as Bronislaw Geremek, a former foreign minister. Mr Geremek refused to complete another vetting declaration, thereby risking his seat in the European Parliament. This prompted huge criticism: Daniel Cohn-Bendit, a Green colleague, said it was like “ordering a Jew in a concentration camp to submit a statement that he hasn't collaborated with the Nazis.”

The Kaczynskis' initial reaction was to counter-attack. At one point they and their allies even seemed to challenge the constitutional court's legitimacy. In a bizarre intervention on the day of its ruling, a deputy from the ruling Law and Justice party, Arkadiusz Mularczyk, demanded a delay, producing hurriedly obtained secret-police files on some of the judges. Now the government has accepted the court's ruling, which guts the central provisions of the law. Journalists and academics are excluded, and the penalty for non-compliance—a ten-year ban from a person's profession—was also struck down.

This has avoided a constitutional crisis, but left the question of what to do with Poland's millions of locked-up secret-police files, which occupy 80km (50 miles) of shelf-space. Secrecy allows the wicked to pose as blameless, and offers much scope for blackmail. The emerging consensus is to replace the vetting law with an open-archive policy. One idea is to allow access by everyone to everything. Yet the files contain much private information, accurate or not, on things like medical conditions or sexual indiscretions.

So a more likely answer will be to open the files to public scrutiny with non-political material expunged. But by whom? Some suspect that the whole subject will now get bogged down in the question of reforming the management of the archives, delaying embarrassing revelations for many years.

Behind the row lie some sharply different views of history. The Kaczynskis believe that, after communism collapsed in 1989, the transition to democracy was botched—maybe even sabotaged—by elements from the old regime. They yearn to bust the crony-capitalist arrangements that have grown up between business, officialdom, the media and leftist politicians. Mr Geremek's 20-year stint in the opposition counts for little: how, critics ask, did he get the juicy job of running the Polish Cultural Centre in Paris in 1960, at the height of the cold war, without having ties to Polish (or Soviet) intelligence?

Others say that the Kaczynskis themselves are prisoners of the suspicious, confrontational mindset engendered by totalitarianism. Justice is one thing; revenge another. Since 1989 Poland has tamed inflation and built a thriving market economy. Now it needs to modernise its public services and play a constructive role in Europe. Ending the heated controversy over the vetting law offers the best chance of concentrating on that.

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Serbia's new government

The eleventh hour

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From The Economist print edition

A welcome new government for Serbia faces the same old problems

Get article background

FREED from political constraints, individual Serbs are showing their countrymen how far they can go. Three are among the best tennis players in the world. On May 12th Marija Serifovic won the Eurovision song contest. The country went wild as the words “Serbia. Winner. 2007” flashed up on screen, and tens of thousands poured into the centre of Belgrade to welcome their heroine home.

Serbs have not had much to feel good about since the former Yugoslavia disintegrated in 1991. If their country is now linked with Ms Serifovic rather than Srebrenica, the site of the wartime massacre of 8,000 Bosnian Muslims in 1995, that shows time is moving on. It is noteworthy that every single former Yugoslav republic gave Ms Serifovic full marks.

If politicians could only put the country's interests above their own, Serbia could escape from the hole it has been in for a year or more. Serbs voted in a general election on January 21st, after which the deadline for forming a government was set for midnight on May 15th. The new government had been approved just 28 minutes before then, but this is hardly cause for congratulation: including its pre-electoral period, Serbia has had no effective government for six months.

Like its predecessor, the new government will be led by Vojislav Kostunica. But this time he must share power with the Democratic Party of Boris Tadic, Serbia's president. Two other coalition partners from the old government remain. Mr Kostunica is a conservative nationalist, but also a democrat. Mr Tadic's party is more liberal, yet over the future of Kosovo, Serbia's secessionist southern province, Mr Tadic has been as hawkish as anyone.

Such a government could have been formed sooner, but the parties fought tooth and nail for every post. The bitterest struggle was for control of the police and the security services. The final week of negotiations saw moments of alarming drama, notably the election on May 8th of Tomislav Nikolic, leader of the extreme nationalist Radical Party, as parliamentary speaker. Mr Nikolic promptly said he was an opponent of joining the European Union, that fellow deputies were traitors and that, because of Kosovo, a state of emergency could be declared.

“Emotionally he moved us back to the 1990s,” says Daniel Sunter, head of Belgrade's Euro-Atlantic Initiative think-tank. “He made the nightmare real again.” Olli Rehn, the EU's enlargement commissioner, said the choice of Mr Nikolic had set Serbia back 20 years; foreign leaders called Mr Kostunica to complain. Such outside pressure irritated some. Braca Grubacic, a commentator, says Serbs think they can take care of their own problems. The drama came to a head on May 11th when a deal was struck on the new government, and Mr Nikolic was duly ousted.

The sigh of relief in Brussels was audible. A grateful Mr Rehn announced that Serbia could soon restart suspended talks with the EU on a stabilisation agreement that may presage eventual membership. He even toned down previous demands that the Serbs must first arrest Ratko Mladic, the Bosnian Serb wartime commander wanted by the UN war-crimes tribunal in The Hague.

The new government's immediate worry is Kosovo. Even on that it may soon relax a bit. Russia and America seem unable to agree on the text of a new UN resolution on Kosovo, so the issue may be postponed again; or a compromise may be reached to defer formal independence. Yet the Kosovo problem will not go away.

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Turkey and Armenia

Clash of civilisations

May 17th 2007 | KARS
From The Economist print edition

Beleaguered Armenians in Turkey—and a closed border with Armenia

Get article background

FOR a seasoned diplomat, Hasan Sultanoglu Zeynalov, Azerbaijan's consul-general in Kars, eastern Turkey, is unusually indiscreet. He openly complains about Naif Alibeyoglu, the mayor, who is promoting dialogue between Turkey, Azerbaijan and their common enemy, Armenia, just over the border. “I don't believe in dialogue,” Mr Zeynalov snorts. He recently ordered his compatriots to boycott an arts festival organised by the mayor after finding that “there were Armenians too.” Like his masters in Baku, Mr Zeynalov is unnerved at the thought of his country's biggest regional ally suddenly making peace with Armenia.

He will have been cheered by the victory of Serzh Sarkisian, Armenia's nationalist prime minister, in a general election on May 12th. Mr Sarkisian is said to have engineered a last-minute ban on Turkish observers of the election. “I think it would be unnatural to receive observing representatives from a country that does not even wish to have a civilised official dialogue,” he commented.

Mr Sarkisian's hawkish views are echoed by Robert Kocharian, the Armenian president, whom he is tipped to succeed in a presidential election next year. Both men hail from Nagorno-Karabakh, a mountainous enclave wrested by the Armenians from Azerbaijan in a vicious war in the early 1990s. This prompted Turkey to seal its border (but not air links) with Armenia in 1993. The effect on Kars's economy has been disastrous, which is why Mr Alibeyoglu is so keen to reopen the border.

Ethnic Azeris, who make up a third of his city's 80,000 residents, are less enthusiastic. They are likely to vote in droves for the far-right MHP party in Turkey's parliamentary election on July 22nd. The party's fortunes have risen on a tide of xenophobic nationalism that has engulfed Turkey. Dismissing opinion polls that give Mr Alibeyoglu's AK party a big lead over its rivals, Oktay Aktas, the local MHP boss, confidently predicts victory. He would like Turkey to invade northern Iraq and to hang the Kurdish PKK rebel leader, Abdullah Ocalan. He also says there is no question of easing the blockade on Armenia—certainly not until it stops referring to his region as western Armenia and calling the mass killings of Ottoman Armenians in 1915 a genocide.

The sensitiveness of the genocide issue was reflected in January in the killing of Hrant Dink, an ethnic-Armenian newspaper editor in Istanbul, who had talked openly about it. The killer was a school dropout from the port of Trabzon. Mr Dink's lawyer, Ergin Cinmen, says there is compelling evidence that the Istanbul police were given warning of a planned attack at least a year ago, but they did nothing to protect

Mr Dink. This week Istanbul's Armenians were shocked once again by a letter sent from Trabzon warning them to defend Turkey against the genocide claims or “face the consequences”. It was delivered to an Armenian primary school.

Such threats have dispelled the surge of goodwill that followed a huge turnout at Mr Dink's funeral and the reopening in March of an old Armenian church restored by Turkey's AK government. Etyen Mahcupyan, who replaced Mr Dink at his newspaper, says some of his kin are now talking of leaving Turkey for good. The border may stay closed for many more years.

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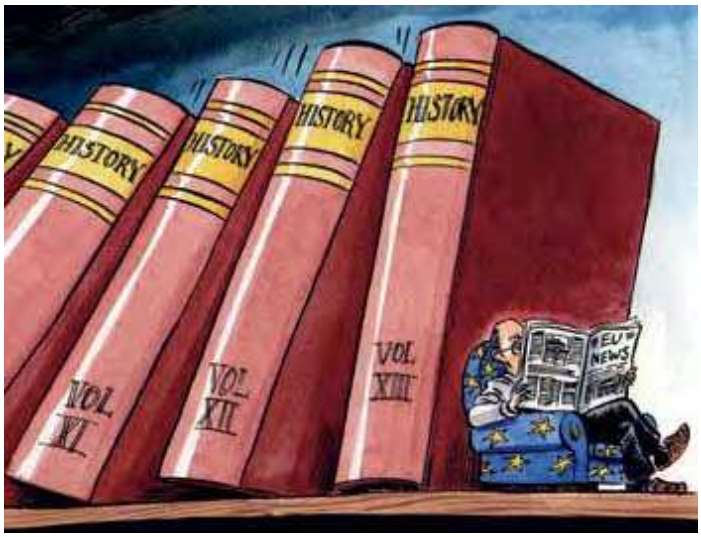
Charlemagne

The burden of history

May 17th 2007
From The Economist print edition

Peter Schrank



Its newest members offer the European Union some history lessons

JAVIER SOLANA, the European Union's top foreign-policy honcho, recently offered a neat turn of phrase to explain the importance that Europeans attach to the past. Ponder the phrase “that's history”, and what it implies on either side of the Atlantic, he suggested. When Americans say something is “history”, they mean it is no longer relevant. When Europeans say the same thing, “they usually mean the opposite”.

Is this mere wordplay? If only. History lies at the heart of many disputes that are causing such angst in today's EU. Thorny topics include Russia's bullying of small Baltic states, fierce rows in such countries as Poland and Romania over how far to probe communist-era collaboration, not to mention the stand-off between Greeks and Turks in Cyprus. Some of these historical quarrels are unfamiliar to western Europeans, and they are often highly inconvenient to boot. Small wonder that a few longer-established union members are handling the arrival of their newer colleagues rather badly.

The EU used to know where it stood on history—it was best kept simple, and in the past. In the early decades, history was about one big thing: the second world war, and the grand project of Franco-German reconciliation. From the outset, the EU was partly meant to make war unthinkable inside Europe. But over the years that miracle of continental forgiveness has ossified into something more inflexible, even smug. Just as pioneering Eurocrats toiled to create single European markets in widgets or wheat, their political masters crafted something approaching an approved single European history (challenged only in awkward-squad Britain, where the war was a matter of national pride). This history portrayed a smooth moral progression from nationalism and conflict (bad) to the sunny uplands of compromise, dialogue and border-free brotherhood (good).

Enlargement is now challenging all this—especially the recent expansion to 27 countries, including ten former communist ones. The clumsy reactions of old EU members are partly to do with ignorance. Enlargement has introduced lots of alien grievances, sending old Brussels hands scurrying to their encyclopedias to mug up on the 1920 Treaty of Trianon (hated in Hungary) and Carinthian plebiscite (it makes Slovenes fume). But less forgivably, some of the insensitivity of older club members carries a whiff of moral superiority, a sense that it is un-European (not to mention uncouth) to bear historical grudges.

European politicians have always been quick to use post-war reconciliation as a cudgel to pre-empt further debate. This can get pretty shameless. Josep Borrell, then president of the European Parliament, once dismissed campaigners against the parliament's nonsensical monthly trek from Brussels to Strasbourg, because they were Swedish: how could Swedes understand that Strasbourg, a much fought-over border

city, symbolised Franco-German reconciliation, he asked. This “historic dimension” was lost on a country that “did not participate” in the second world war (though nor did Mr Borrell's—he is from Spain).

Lofty talk of European brotherhood also conceals the fact that, even among the founder members of the club, there are deep differences about how to reconcile societies with their past. At one end is the German model of swift and repeated repentance. Other countries took much longer to break with post-war silence and myth-making (France springs to mind). Still others moved on from dictatorship to democracy via pacts of national amnesia that are only now being challenged (think of Spain). It is striking that French politicians have been vocal critics of the Polish government over its recent (admittedly cack-handed) project to cleanse public life of former collaborators (see article). German politicians, with their tradition of purgative truth-telling, have been more muted.

In victory, defeat

Above all, the authorised version of European history has floundered in the face of new members for whom the second world war is not the end of any debate, but a starting-point for new rows. The EU now has a fistful of ex-communist countries for whom, as one Brussels official puts it, “Strasbourg is not a symbol, and 1945 is not a magic year”. When Polish politicians mention Auschwitz, it is often to complain about it being called a “Polish death camp”, rather than the wording they feel is correct: a Nazi death camp located in Poland. The latest row between Estonia and Russia concerns the relocation of a Soviet war monument from the centre of Tallinn. Earlier this year, the Baltics led an unsuccessful push to add Stalin's crimes to an EU directive covering Holocaust denial.

This is not to say that the newcomers inevitably have right on their side. Some nasty anti-Semites lurk within Polish politics. The Baltics mis-timed their push for recognition of Stalin's crimes: a directive about racism and xenophobia was the wrong vehicle. But that is no excuse for the impatient eye-rolling with which newcomers are often greeted when they air historical grievances. (During a discussion of Estonia's war-memorial row, the German ambassador to the EU observed cheerfully that Berlin was still home to Soviet war monuments, and even sculptures of Lenin, as if that was comparable.)

It matters that the EU has a tin ear for some of its members' historical memories. It is, at the least, bad manners—not to mention bad tactics when dealing with Russian assertiveness. In future, history may matter still more, assuming that the union follows strategic logic and enlarges once more to take in new members from the Balkans (and perhaps Turkey, even if that is a lot further off). These are rough neighbourhoods, where history can still get people killed. If the EU does not learn to listen to and understand different views of the past, it may find itself stumbling when confronting future conflicts inside and outside the union. And that would be an historic mistake.

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Gordon Brown's shadow campaign

How to look like a prime minister

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From The Economist print edition

Reuters

What the man in Number 11 is trying to do before he moves next door

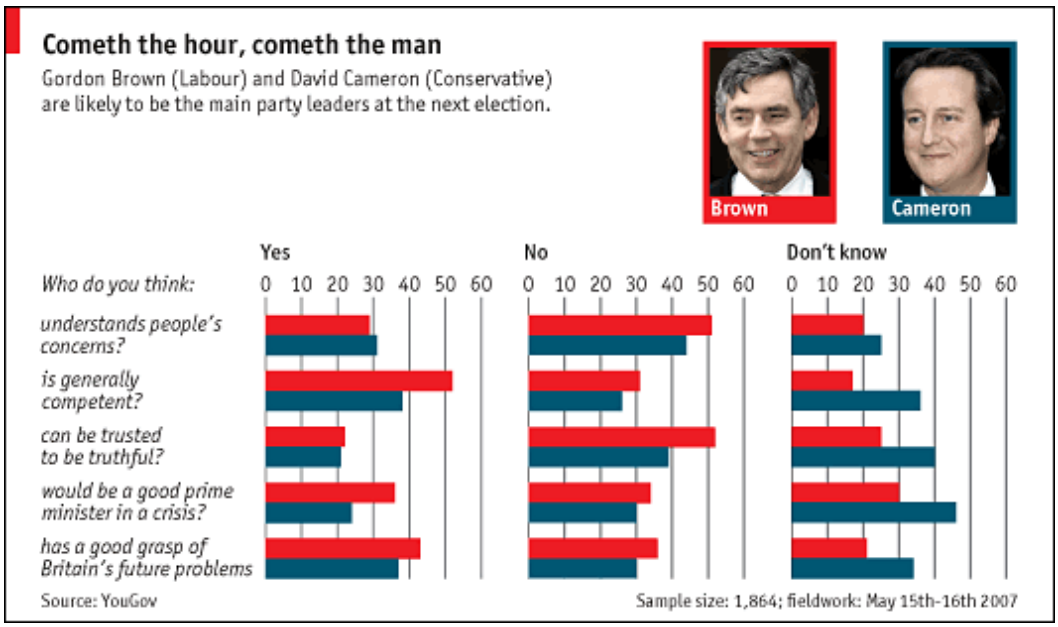
Gordon Brown

GIVEN how long it spent in what a dotcom business would call beta, Gordon Brown's shadow campaign for prime minister has been surprisingly glitch-prone since it went live. On day one, television cameras followed him about on the trail, only to film a door being shut in his face by someone who had failed to realise his luck in having Britain's future leader drop by. Later on, his famous jaw was obscured by an autocue while he delivered a speech, making him look like a very important man trying to talk through a closed window. An earlier struggle with celebratory balloons (above) should have put Mr Brown's handlers on their guard.

They are not too worried about such mishaps, however, because this contest is not actually about who wins and who loses. Mr Brown has a campaign team, a strategy and scores of enthusiastic backers, but nothing as inconvenient as an opponent. Instead, in the weeks between now and June 27th, when Tony Blair steps down as prime minister, Mr Brown will be engaged in a bout of shadow-boxing that will determine whether voters think of him as a new version of Mr Blair—one capable of delivering on his promises—or just the old model without the charisma.

Even though Mr Brown has been the second-most famous politician in Britain for a decade, the electorate has not decided which of these two he is. Rick Nye of Populus, a pollster, describes him as “a known unknown”. Happily for Mr Brown, the early signs are that people like him a little better than they thought they might. One source of gloom for Labour over the past few months has been that the Conservative lead widened when pollsters asked people how they would vote if the party were led by Mr Brown rather than under current management. As this hypothesis becomes less hypothetical, the difference has narrowed and Labour's poll rating has picked up a little.

A poll by YouGov for *The Economist* this week shows Mr Brown outperforming David Cameron, the Tory leader, on general competence and the ability to handle a crisis (see chart). On the other hand, Mr Brown draws many more negative responses on every issue than does Mr Cameron, about whom people are still reserving judgment. Compared with Mr Blair's ratings before he came to power in 1997, both men are doing badly. It is hard to know which of these five measures is the best predictor of where a pencil hesitating over a ballot paper would fall, but neither Mr Brown nor Mr Cameron can claim to have won the trust of the electorate.



Mr Brown scores poorly on empathy, which is why he will be spending the next few weeks doing lots of public meetings in swing seats, raising his eyebrows and nodding in a way that signifies listening. This strategy worked for John Major in the 1992 general-election campaign, when he swapped television studios for a soapbox. People close to Mr Brown insist he is just as affable and inspiring as Mr Blair but has been prevented from showing it while at the Treasury, where loose talk either upsets financial markets or makes other ministers worry that their budgets are about to be shredded. Wandering around and chatting to people is what he really enjoys, says one minister who is backing him. This is a touch over the top: Mr Brown tends to come across as someone who knows all the answers already.

That sense of having it all worked out may even be part of his appeal. For the past two years, Mr Brown's supporters have been worrying about what trick he might produce to match the impact of giving the Bank of England the power to set interest rates in 1997. Now they have more or less given up looking, but are also confident that new policies are not what is wanted. One Labour MP sympathetic to Mr Brown says his man is so solid already in this area that all he needs to do is show “some glimpses of ankle” from time to time. So far, those glimpses have tended to reinforce Mr Brown's strengths against Mr Cameron, while distancing him a bit from his predecessor.

Whereas Mr Blair sometimes seemed to care little for Parliament, Mr Brown has pushed to give MPs the power to approve any declaration of war and hinted at more time to scrutinise legislation. He also says that policy announcements should be made to the House of Commons rather than to the press (one of Mr Brown's worst days as chancellor was when he woke up to discover that Mr Blair had committed the government to a huge rise in health-care spending on a breakfast-television show). Mr Brown has followed Mr Blair in making education his top priority, but has identified the number of children who leave school innumerate as something that his predecessor has failed to fix. Listening hard, he is promising a review.

Against Mr Cameron, Mr Brown aims to be all strength and seriousness. Whereas the Conservative leader advertises his concern for the environment by attaching a toy windmill to his home, Mr Brown will build five whole towns filled with green houses. While Mr Cameron waffles on about social responsibility, Mr Brown will build more social housing for people who cannot afford to buy or to rent privately. His team also thinks that releasing constraints on private house-building will be popular and hard for the Conservative Party, with its power base in England's densely-populated south-east, to accept.

All of which should please those Labour MPs who have sometimes felt more like spectators than members of a governing party over the past decade, and may even persuade people that Mr Brown is keener on straight talking than on shaping the evening news. Unlikely, but maybe those early blunders were not as careless as they looked.

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Scottish politics

Salmond's leap

May 17th 2007 | EDINBURGH
From The Economist print edition

Gordon Brown has an uncomfortable new neighbour in the north

Get article background

Reuters

A man to reckon with

GETTING the better of David Cameron's Tories may be Gordon Brown's first priority when he becomes prime minister, but dealing with Alex Salmond's Scottish National Party (SNP) cannot be far behind. Mr Salmond, who was elected first minister of Scotland on May 16th, could even prove the tougher adversary.

The SNP's victory in the elections to the Scottish Parliament two weeks ago was historic. Not since 1959 had a party outpolled Labour among Scottish voters. Of the 20 seats the SNP gained, nine were taken from Labour. They include, threateningly for Mr Brown, a constituency that borders his own Kirkcaldy seat—Fife Central, Labour for the past half-century. Mr Brown cannot count on Scotland to keep delivering the solid block of 41 Labour MPs that it did in 2005.

But Mr Brown has more to fear from Mr Salmond than the odd electoral *frisson*. Since many powers were devolved to Scotland in 1999, Labour has ruled both at Holyrood and at Westminster. Most squabbles between the two were minor, and behind closed doors. Mr Brown will not have that luxury. Scotland's new first minister is a man with a mission—Scottish independence—and it is not one that the equally Scottish Mr Brown subscribes to.

Mr Salmond has long thought that Scottish independence cannot be won until Labour is defeated in its heartland. After the first referendum on Scottish devolution in 1979 and the SNP's poor performance in the general election that year, he even urged the party to take on Labour directly, becoming an avowedly left-wing socialist party to do so. This got him thrown out of the SNP, briefly, in 1983.

He later dismayed his leftist colleagues by abandoning the tussle with Labour in urban Scotland and running for MP in 1987 instead in rural Banff and Buchan, then a Tory constituency. He was also suspected (correctly) by party fundamentalists of considering the gradual accumulation of powers under devolution a more likely route to independence than a big-bang electoral victory. But he persuaded both to elect him party leader in 1990, a post he later left and then resumed in 2004. Though he scorns New Labour's policies, he has aped its electoral strategy, successfully courting once-hostile groups such as business and pensioners.

Mr Salmond is a politician of sinuous skills and thirsting ambition, but he has a difficult task. Because he could not persuade any biggish party to form a coalition with the independence-minded SNP, he heads a minority government at Holyrood. He still has a parliamentary seat at Westminster, however, and will no doubt use it to heckle the new prime minister about ceding more powers to Scotland.

Taking office this week, Mr Salmond promised “compromise and intelligent debate”. An economist and a wily tactician, Mr Salmond can be expected to bring plenty of intelligence to these jousts. It would be unlike Mr Brown to respond with much compromise.

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Immigration

Come and fall on Slough

May 17th 2007
From The Economist print edition

Councils demand more cash to cope with migration

Get article background

PLUMBERS, or a lack of them, were one reason for the warm welcome Britain gave the eight eastern European nations that joined the EU in 2004. A few thousand skilled migrants seemed exactly what the economy needed. Officials sat back and awaited the new arrivals—about 30,000 or so, they assumed. Two years later, some 600,000 eager migrants had turned up, providing more than enough handymen for a small island. Now the government is more cautious. Romanians and Bulgarians, whose countries joined the EU in January, may enter Britain freely, but they are not allowed to work or claim state support.

Plenty are coming anyway. Slough, a smallish town on the outskirts of London, says that about 400 Romanian Roma (or gypsies) have moved in since January 1st. (No one is quite sure why they have chosen Slough; they may know the small group of Romanian refugees who settled there around 2000.) Banned from working or claiming benefits, the newcomers are thought to be making a living through trading, odd jobs, begging and some petty crime. The council says multiple families are cramming into cheap rented rooms in order to save money. The rage of some British newspapers is matched only by Romania's, which fears (sadly, correctly) that the Roma are giving their country a bad name.

This week it emerged that 88 of Slough's Roma are unaccompanied minors. The young migrants came in small sibling groups, travelling in the backs of lorries for €75 (£51) apiece. Six had babies of their own, and seven were pregnant.

Lone minors of any nationality are entitled to a bed, a £45 ($89) weekly food allowance, a one-off £100 clothing grant, health care and, if they are under 16, free schooling. Perversely, being accompanied by an adult would immediately deprive them of these benefits. Slough is trying to reunite its newcomers with their families in Romania, but without much luck. Instead, 35 have been sent to live with relatives in Britain. The rest are with foster families or in hostels. So far, supporting these young arrivals has cost Slough £150,000.

Few councils suffer such crises, but many are unhappy at what they see as the unrecognised burden that immigration imposes on them. Official statistics on EU migration are shaky, partly because many newcomers are self-employed and don't register as workers, and partly because departures often are not recorded. Last month a new official approach to counting heads claimed that some areas had fewer migrants than was previously thought.

This is explosive stuff, since the size of a council's grant from central government is partly based on population. Resentful locals already say that immigrants stretch their services and increase their taxes. Westminster council, in central London, reckons it will now lose £6m a year because its officially recognised migrants may fall by 15,500. Three other nearby councils have made the same complaint.

Landing strips such as London probably scored disproportionately highly under the old way of counting immigrants, says John Salt of University College London. This relied on census data and a survey of international passengers' intentions. “A lot of people first say they are going to London, but we know that quite a lot of them later move on,” says Mr Salt.

The new method takes in the Labour Force Survey, a house-to-house questionnaire, to give a better idea of who has moved where since touching down. It is expected to show that six of the ten biggest drops will be in and around the capital, whereas smaller cities will see increases.

Unfair, say the losers. The new approach does not include anyone planning to stay in Britain for less than a year, meaning that transit points such as London probably have many unrecorded new inhabitants. (Someone who is around for 11 months will still use plenty of local services, councils point out.) And

household surveys are a bad way to poll new migrants, since they exclude anyone who lives in a hostel, works awkward hours or isn't confident in English.

Councils are compiling their own rival statistics. Slough says it has seen a sharp rise in national-insurance applications, for example. And to prove how busy the town has become, the council even measured local sewage flow: in the year to April 2006 it swelled by more than 10%.

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Ancient history

Athens v Sparta

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From The Economist print edition

PA

O Tempora! O Mores!

DEMONSTRATORS outside Parliament rarely wear togas and brandish placards written in classical Greek. They did this week. The reason was a decision by education bureaucrats to drop a national history exam for 18-year-olds. If the protest naught avails, ancient history will no longer be taught in English schools, for the first time since the original Dark Ages.

The decision to axe the A-level was taken hurriedly and in secret, without consulting the schools that teach ancient history or the universities that like it. And it comes at a time when the decline in classics in schools has reversed. A recent book on Latin grammar, “Amo, Amas, Amat”, became a surprise best-seller. The number of state schools offering basic Latin has risen from 200 in 2003 to 459 today. Though some of the Thucydides-loving demonstrators were from elite private schools, others were from grungy further-education colleges.

As they waited for Boris Johnson, the Tory education spokesman, to address them (in Latin), the pupil-protesters chanted “Long live Athens! Down with Sparta”. Fine sentiments. But remember what happened to Athens.

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Fertility treatment

Making babies, the hard way

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IVF is now commonplace. It needs to be regulated with a lighter touch

DOCTORS at the Hammersmith Hospital in west London have been carrying out *in vitro* fertilisation (IVF) for more than two decades. Lord Winston, Britain's best-known fertility specialist, writes of the hand-to-mouth early days, when patients were counselled in a disused broom cupboard and research was done in derelict huts. The desperate pioneers willing to try anything to have a baby were treated free, subsidised by Lord Winston's private surgical practice. All decisions were made by the patient and doctor alone.

Lord Winston is now retired, but the centre he founded flourishes, carrying out 1,000 IVF attempts each year and playing a part in the birth of around 300 babies. Half these treatments are paid for privately—the cost is £2,500, plus thousands more for drugs—and taxpayers finance the rest. Stuart Lavery, one of the two consultants at the clinic, talks with pride of its slick operation, the “earthquake-proof” table where sperm and eggs meet, and the joystick-controlled operating microscope, which permits single cells to be taken from embryos and tested for genetic ailments. All treatments and research are overseen by a national regulator, the Human Fertilisation and Embryology Authority (HFEA).

On May 17th the Department of Health published a draft Human Tissue and Embryos bill, which updates the 1990 Act that brought the HFEA into existence. New law is needed in part to keep pace with scientific advances. For example, embryos created by decanting the contents of an adult cell into the shell of an unfertilised egg—a recent technology that may help to find cures for dread diseases—now fall within its remit. It sets out when embryos may be screened in order to choose those that are free from genetic diseases or that could make suitable donors for an existing sibling who is ill. And it relaxes a much-criticised proposal to ban blue-skies research that combines human and animal genetic material.

Also included are responses to a couple of controversial recent cases. One is that of Natallie Evans, who took fertility drugs and had embryos frozen before a cancer treatment that destroyed her fertility, only to see her boyfriend withdraw his consent for their use once the two had separated. Under the draft law, both parties will still have to consent before frozen embryos can be used, but if one has a change of heart the embryos will be kept for a year—in case the heart changes back.

Another tough decision was thrown up by the plight of the Mastertons, a couple with four sons and a daughter. Mrs Masterton had been sterilised after the birth of their longed-for girl, who later died in an accident. She wanted to do IVF and have only female embryos returned to her womb. The HFEA decided not to allow such a practice, though the law gave no guidance. Now sex selection is to be banned explicitly, except in cases where it would avoid the birth of children with sex-linked genetic diseases.

Yet the new legislation fails to address the biggest problem of all: burdensome, costly regulation. According to the Science and Technology Committee, a cross-party group of MPs, Britain is heavier-handed than anywhere else in the world, and it does not pay off in better results. Rules date from a time when there were serious doubts about both the safety and morality of IVF. Those doubts seem anachronistic now that IVF is responsible for more than one birth in 100 and the average primary school has a clutch of test-tube babies.

Research is held back by the six-month wait for a licence for each separate procedure. Women see their fertility wane as doctors wait for the go-ahead to carry out non-standard clinical procedures, even ones that are uncontroversial and similar to those the clinic is already licensed to offer. Patients must pay £100 per IVF cycle just to register it with the HFEA. The Hammersmith unit spends £115,000 a year on licence fees, and employs two people to deal with the paperwork.

Under the proposed law, regulation may become still more onerous. The HFEA is to be rolled into a new “Regulatory Authority for Tissue and Embryos”, which will also absorb the Human Tissues Authority, the body that oversees transplanting and disposal of human body parts. Doctors fear that it may insist on uniform standards across these disparate fields, even though equipping a clinic to the highest standards of

antisepsis costs £1.6m and is unnecessary for IVF. As Mr Lavery points out, “sperm isn't exactly donated in a sterile environment in nature.”

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Inflation and interest rates

I've got a hammer

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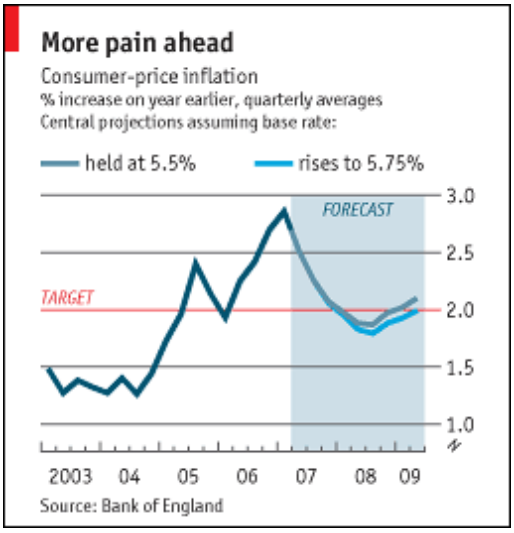
The bank wants to nail down inflationary expectations

Get article background



AFTER serving up an unpleasant surprise for the Bank of England last month, official statisticians brought more palatable tidings this week. Annual consumer-price inflation, which had surged from 2.8% in February to 3.1% in March—triggering a public letter to explain why it had diverged so far from the 2.0% target—fell back to 2.8% in April. Retail-price inflation, a broader and more realistic measure, dropped from 4.8% to 4.5%.

The reduction in inflation is set to continue, according to the bank's latest central forecasts, published this week in its quarterly *Inflation Report*. These show that consumer prices should be rising at around the 2.0% target rate by the turn of the year. The sharp fall in inflation reflects the fact that households' energy costs, whose steep increase in 2006 did much to drive up overall inflation, are forecast to fall by a fifth in the year to early 2008. This reversal is already under way and largely explains why inflation fell back in April.

The brightening short-term outlook for inflation, however, does not augur an end to the monetary tightening that has lifted interest rates from 4.5% last summer to 5.5% on May 10th. When the bank's monetary-policy committee (MPC) sets rates it looks some time ahead, since rate changes take around two years to exert their full impact on inflation. The bank's projections suggest that the MPC has some unfinished business. If the base rate stays at 5.5%, inflation would be a bit above the 2.0% target in two years' time. It hits the target in spring 2009 only if the rate rises later this year to 5.75%, as the markets expect (see chart).

Indeed, the bank may not stop there. Even if its forecast assumes another quarter-point rise in base rates, it says that the risks to inflation are “weighted to the upside in the medium term”. This suggests that interest rates may need to go still higher than 5.75%.

The main inflationary risk, said Mervyn King, the bank's governor, on May 16th, is “that businesses become more confident of their ability to raise prices and in turn pay higher wages”. Already, surveys of firms have revealed that more of them are intending to push up prices. The bank's regional agents have been hearing a similar story. There has been a broadly based change in the pricing climate, said Mr King. The worry is that if firms do raise prices aggressively, this will reduce the relief from tumbling domestic-energy bills, and inflation will be higher than the path shown in the central forecast.

One reason to be more sanguine is that pay settlements so far this year have been quite restrained. Higher unemployment and the greater availability of migrant labour appear to be holding wages down. The slack in the labour market is growing, according to official figures released on May 16th. These showed a fall in employment of 55,000 between the last quarter of 2006 and the first quarter of 2007. The unemployment rate now stands at 5.5%, up from 5.2% a year before.

On balance, however, the MPC remains nervous about the outlook for inflation. It is forecasting quite strong GDP growth over the next couple of years, based on steady increases in consumer spending, buoyant business investment, and a boost to exports from a continuing recovery in the euro area. The labour market may be loose but spare capacity within business is “relatively limited”. Furthermore, Mr King remains worried about the current growth rate of money and credit, saying that “it is high, it is a concern.”

Against this background, it is hardly surprising that the *Inflation Report* struck a hawkish note. The bank is worried that people are starting to expect higher inflation. It wants to nail those expectations back down to the 2.0% target.

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Freedom of information

Parliamentary scrutiny

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A plan to exempt MPs from scrutiny

ONE of Labour's hoariest manifesto pledges—promised to voters for over 25 years—was to bring in legislation to illuminate the notoriously dark corridors of government. Amid inspiring talk about the public's right to know, Tony Blair signed the Freedom of Information Act (FOIA) into law in 2000.

Lately though the powers that be seem to be having second thoughts. Last year the government proposed making it easier for civil servants to reject requests and limiting the number of queries allowed each year to any person or organisation. Now Parliament is debating whether to go further. David Maclean, a Conservative MP and former whip, is sponsoring a private member's bill that would remove the Lords and the Commons from the scope of the FOIA, and exempt MPs' communications with public authorities from disclosure.

Most private members' bills never make it into law, and Mr Maclean has been modest about his bill's prospects. But it has in fact done rather well: introduced in December last year, it has passed its second reading and is due for debate again on May 18th. Such endurance suggests that it is more popular than Mr Maclean lets on. That was confirmed on May 14th, when the Campaign for Freedom of Information (CFOI), a lobbying outfit, published an e-mail from Labour's parliamentary leaders advising their MPs to vote for the bill.

Supporters argue that amending the act is necessary to prevent busybodies from forcing MPs to publish letters from or about their constituents, which ought to remain private. “The kindest thing to say is that this is based on a total misunderstanding of the legislation,” notes Maurice Frankel, head of the CFOI. He says that members' correspondence is already safeguarded under both the existing FOIA and data-protection laws.

Cynics detect darker motives. In February Norman Baker, a Liberal Democrat MP, used the FOIA to publish detailed breakdowns of members' travel expenses (after a long battle with parliamentary authorities), which led to awkward questions about value for money. Such questions can spell electoral disaster: David McLetchie, the leader of the Conservative Party in the devolved Scottish Parliament (which has its own act), was forced recently to resign over irregularities in his expenses. Nor is it just members' allowances that Mr McLean would exempt from disclosure: all parliamentary correspondence with officialdom would be kept secret.

Not all lawmakers are in favour of the proposal. The Liberal Democrats have condemned it, and several cabinet ministers are thought to be opposed. FOIA fans hope that the arrival of Gordon Brown—currently chancellor of the exchequer—into the top job next month may strengthen their hand. Aware of Mr Blair's reputation for spin and dissembling, Mr Brown has been promising a “new era of openness” in government. Sinking this bill would be an excellent place to start.

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Bagehot

How much is left of the left?

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Steve O'Brien

Despite the lack of opposition to Gordon Brown, New Labour's roots are still shallow

ON THE face of it, the failure of John McDonnell is reassuring to those who insist that, in spite of the imminent departure of Tony Blair, there will be no retreat from New Labour's centrist ways. The sole leadership candidate of the Labour left, Mr McDonnell was unable to secure the 44 nominations from other MPs to get himself on the ballot by Thursday's deadline.

It was not through want of effort. Mr McDonnell declared his candidacy in July last year and has tramped the country giving speeches to potential supporters. As a thorn in the side of the government, his credentials are impeccable. In the parliament that sat from 2001 to 2005, for example, he voted against the Labour Party whips 135 times.

Yet despite his record of insurrection, Mr McDonnell does not come across as a rabid revolutionary. He is calm and humorous. It's just that he disagrees with almost everything that Mr Blair's government—and, by extension, Gordon Brown's—has stood for. In particular, he believes the Iraq war is illegal and conducted in the interests of corporate America; he is against what he describes as the “privatisation” of public services; he thinks rich people, especially the recipients of big City bonuses, should be taxed more heavily; and he criticises the government for restricting civil liberties. In other words, Mr McDonnell subscribes to views that a great many people who think of themselves as being vaguely “on the left” share.

Nor is there a shortage of serial rebels on the Labour benches. Around 60 of them defied the whips on ten or more occasions during the last parliament. And there were big revolts against Mr Blair's education bill and the renewal of the Trident missile system in this parliament, both of which were carried only with Tory help. So it is somewhat surprising that Mr McDonnell succeeded in winning the nomination of so few of his colleagues.

There are four possible reasons for this. The first is that despite the calls for a leadership contest from party members, there is no appetite for one among the vast majority of Labour MPs. A second is that for all Mr McDonnell's mild manner, his colleagues know he is closer to the hard left than he seems (when “Red Ken” Livingstone, as he was in those days, ran the Greater London Council in the 1980s, he sacked Mr McDonnell as his deputy for being too left-wing). Third, Mr Brown is seen as sufficiently to the left of Mr Blair to placate those MPs who in recent years may have wondered if they went to sleep and woke up in the wrong party. A final reason is that perhaps Labour has ceased to be a party of the left on any sensible

definition.

There is something in the first two explanations, rather less in the third and almost none in the last. Allowing Mr McDonnell a national platform for the sake of a largely meaningless contest was of limited appeal. That said, the mood of most backbenchers is not one of elation at the prospect of Mr Brown's elevation. He may be better than Mr Blair at hitting Labour's hot buttons, but they know that policies will be broadly unchanged.

The rebellions against three of Mr Blair's key public service reforms accurately reflected the sentiments of many ordinary Labour MPs. They disliked semi-independent foundation hospitals, differential university-tuition fees and freer trust schools for much the same reasons. All three measures were designed to bring some competition to different spheres of the public sector in the belief that this would drive up standards.

But to many Labour backbenchers, these ideas are still deeply troubling, intended to pit hospital against hospital, university against university and school against school. They persist in a romantic vision of a public realm based on a co-operative model in which the public-service ethos is allowed to shine through unchallenged. Labour may have given up its attachment to public ownership and controlling large parts of the economy, but its first instinct is still to distrust the market as a policy tool.

A fragile plant

With the return to obscurity of Mr McDonnell, the deputy leadership election assumes greater importance—not because the job matters greatly, but because of what it is likely to say about New Labour's shallow roots. Aside from the relentlessly on-message party chairman, Hazel Blears, none of the candidates, including the new favourite, Alan Johnson, the education secretary, could be described as fervent Blairites. Hilary Benn, the overseas-development secretary and the bookies' early favourite, struggled to secure the votes he needed because of conveniently timed press interest in some personal shareholdings that turned out to be much ado about nothing. On the other hand, he may have suffered for speaking out more clearly than his rivals in defence of Mr Blair's idealistic motives in going to war in Iraq.

It will be interesting to see, over the next six weeks, just how far the contestants are prepared to go in sucking up to the prejudices of party and union members, who, between them, account for two thirds of the votes in Labour's electoral college. There is much talk already about reconnecting with the (shamefully neglected) grassroots and the historic importance of the link with ordinary working people through the (shamefully neglected) relationship with the unions.

The demise of Mr McDonnell is proof that the old hard left which almost destroyed the party 25 years ago has all but disappeared. But that does not mean New Labour is as deeply embedded as both Mr Blair and Mr Brown would like us to believe. Though it is hard to distinguish precise ideological shades, among Labour backbenchers the soft left is almost certainly more numerous than true-believing Blairites and Brownites.

Some part of Labour's electoral success has come from Mr Blair's unique ability to shield the electorate from that reality. For all Mr Brown's determination that Labour should not vacate the centre ground, voters may start to see his party differently.

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Paul Wolfowitz

An outsider's fate

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AP

Even as it appears to reach its grisly end, the battle to oust the World Bank chief says as much about the institution as about him

IT WOULD not be the first time the great powers had gathered in Potsdam to sort out the aftermath of a long-running conflict. The city, where the Allies divvied up Germany after the second world war, will this weekend welcome the finance ministers from the G8 group of rich countries. As *The Economist* went to press, Paul Wolfowitz, the World Bank's president, was still scheduled to join them. If he gets to Potsdam, it could be one of his last acts after a protracted battle to keep his job.

On May 14th, a report written by seven of the bank's directors concluded that in the summer of 2005 he had broken the institution's rules, breached his contract and fallen short of the high ethical standards of his office. All of this in an effort to appease Shaha Riza, his romantic partner, who was outraged that she would have to leave her job in the bank when he took his. He went to huge lengths to smooth his girlfriend's exit, bowing to her demand for a substantial rise in pay, sharp annual increases and a big promotion (or two) on her return. He should never have put himself in the middle of the dispute, the report argued. He was only following the directors' sketchy advice as he had understood it, Mr Wolfowitz insisted in reply.

He and his backers in the American government are keen to disentangle the Shaha Riza question (a muddle and a mistake, but not a “firing offence”, they said) from the broader question of his stewardship of the bank. But the directors' investigation shed an unflattering light on both the president and his girlfriend. Mr Wolfowitz “saw himself as the outsider to whom the established rules and standards did not apply”, it found. Both he and Ms Riza shared the angry conviction that they were being held to a different standard than previous bigwigs. Ms Riza's demands apparently flowed from that indignation, allied to her belief that as “a Muslim Arab woman who dared to question the status quo” she had faced discrimination at the bank in the past.

Mr Wolfowitz thinks the bank's directors served him badly then, and feels the same of this week's report. It reserves little criticism for the directors' own ethics committee, for example, which was sloppy in its handling of the original case. The committee says it never intended Mr Wolfowitz to get elbow-deep in the dispute, but it was also too quick to wash its own hands of the affair. (When Mr Wolfowitz points this out to his investigators, they accuse him of seeking to blame others.) The report bemoans the damage the affair has done to the bank's credibility in the outside world, but also attacks Mr Wolfowitz for publicly defending his conduct. All his attempts to dig himself out of his considerable hole have only deepened it.

Perhaps his fate was inevitable. “Could ‘the architect of Iraq’ ever be accepted by staff?” John Briscoe, the bank's country director for Brazil, asked in a recent letter to his colleagues. “The answer is probably no.” A poll by the Staff Association showed 92% opposed his appointment. That suggested “an organised hostility” from the bank's cadres that would always be hard to overcome, Mr Briscoe argues.

But Mr Wolfowitz did enjoy a decent honeymoon after he took up office. Many staffers, encountering him in the canteen or in early meetings, were surprised by his lack of bluster and vainglory. Some of those opposed to his past were willing to set it aside, much as they had forgiven Robert McNamara, a previous bank president, his role as America's secretary of defence during the Vietnam War. They were prepared to give Mr Wolfowitz the benefit of the doubt. Did he return that compliment?

His closest aides were those he brought with him from the Bush administration: Robin Cleveland and Kevin Kellems. Newcomers to the institution, they were each given lofty ranks and generous salaries calculated to impress old bank hands. Instead they irked and demoralised them. The career staff felt Mr Wolfowitz treated them with the same scepticism he had famously shown towards America's intelligence establishment in the 1970s, as a member of the CIA's more hawkish “Team B”.

Belatedly, the bank's president has recognised the distrust he had sown. He told the bank's directors this week that he should have let the career staff do many of the tasks that he instead entrusted to his familiars. One member of his Team B, Mr Kellems, has already resigned; another, Ms Cleveland, has previously said she will not stay any longer than Mr Wolfowitz.

The bank's rank-and-file have now acquired a taste for open revolt. But in truth the bank is rarely at peace with itself for long. James Wolfensohn, Mr Wolfowitz's predecessor, also brought in his own entourage, and antagonised bank veterans, even as they patronised him. The main difference is that Mr Wolfensohn did most of his own shrieking and shouting, whereas Mr Wolfowitz pays others to bark for him.

A new president inherits a corps of 8,600 highly qualified and experienced staff in full command of a jargon and house culture that can bewilder new bosses. Some in the top ranks are attached to the status quo which has served them so well. “The bank has a set rhythm,” says Ashraf Ghani, chancellor of Kabul University, who once worked at the institution. But a president cannot change those rhythms and routines until he has first mastered them.

Mr Wolfowitz learned this lesson the hard way. He wanted to make the bank tougher on corruption, having observed Indonesia's crony capitalism as ambassador in Jakarta. Last year he began suspending loans destined for projects or governments scarred by malfeasance. His decisions, which he described as mere common sense, provoked a year of intellectual and institutional squabbling. The “rhythms of the bank” had been rudely interrupted, disturbing borrowers, donors and staff alike. He “waded into the crusade against corruption without a game plan”, Mr Briscoe noted. Instead of formulating a plan, selling it to the bank's board, customers and officers, and then acting on it, Mr Wolfowitz acted first, and had a strategy thrust on him later.

The bank has since reached a truce on the issue of corruption. But it remains troubled by other doubts about its place in the world. It must fight not to lose its most lucrative customers—such as Brazil and Mexico—to the capital markets, which now rush in where once only the bank dared to tread. It must also battle not to lose aid dollars to other, more fashionable conduits for generosity: the presidential plans, millennium accounts, global funds and so on, all proffering their begging bowls.

But the bank's first priority is to restore the morale of the staff without entirely alienating the Bush administration. Given the tenacity with which it has fought for its man, one would assume the White House cherishes the bank. In fact they appear to care little about the institution, and know even less. The Republicans have left it shortchanged, even though one of their own is at the helm. Now some of the bank's more hysterical critics think it is threatened by a European coup. If the regime were to fall, the risk is that the administration will take revenge by putting its money elsewhere.

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Abortion

A question of life and death

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The struggle between “pro-choice” and “pro-life” forces around the world

Reuters

Mexico's passions

THE scan showed the four-month-old fetus had anencephaly, a rare, incurable condition; the baby would be born without a scalp or most of its brain. It could live only a few days. The mother, an unmarried 17-year-old known as Miss D, wanted an abortion. But in her native Ireland, abortion is banned unless the mother's life is at risk. The health authorities would not let her leave the country for a termination. On May 9th Ireland's High Court ruled that Miss D should be allowed to go to Britain to have the procedure. The unborn baby's “right to life”, enshrined in the constitution, did not take precedence over Miss D's right to travel, it suggested.

On the same day, Pope Benedict, starting his first visit to Latin America, reiterated the Vatican's deep opposition to abortion: the politicians in Mexico City who had just voted to legalise the practice were excommunicating themselves, he said. This was “not something arbitrary”, but part of long-established canon law.

At the other end of the debate over abortion is China, where the practice is controversial not because it is banned but because it is obligatory—for mothers whose pregnancy violates strict curbs on family size. News came this week of a father who was fined 600,000 yuan ($78,000) for breaking the “one-child” policy, which came into force in 1979. Meanwhile, in the United States, abortion promises once again to be a big issue in the next presidential race. Rudy Giuliani, the Republican front-runner, is struggling to avoid alienating conservative voters with his mildly “pro-choice” line.

Four decades after controversy over abortion and the law began to sweep the world, the battle between the “pro-lifers” and “pro-choicers”—with its heady mix of sex, religion and morality—rages on. Supporters of easier access to legal abortion say that despite reversals in some places, and staunch resistance in others, their cause is advancing. According to the New York-based Centre for Reproductive Rights, over 60% of the world's 6.5 billion people now live in countries where abortion is generally allowed. Just a quarter live in states where it is generally banned.

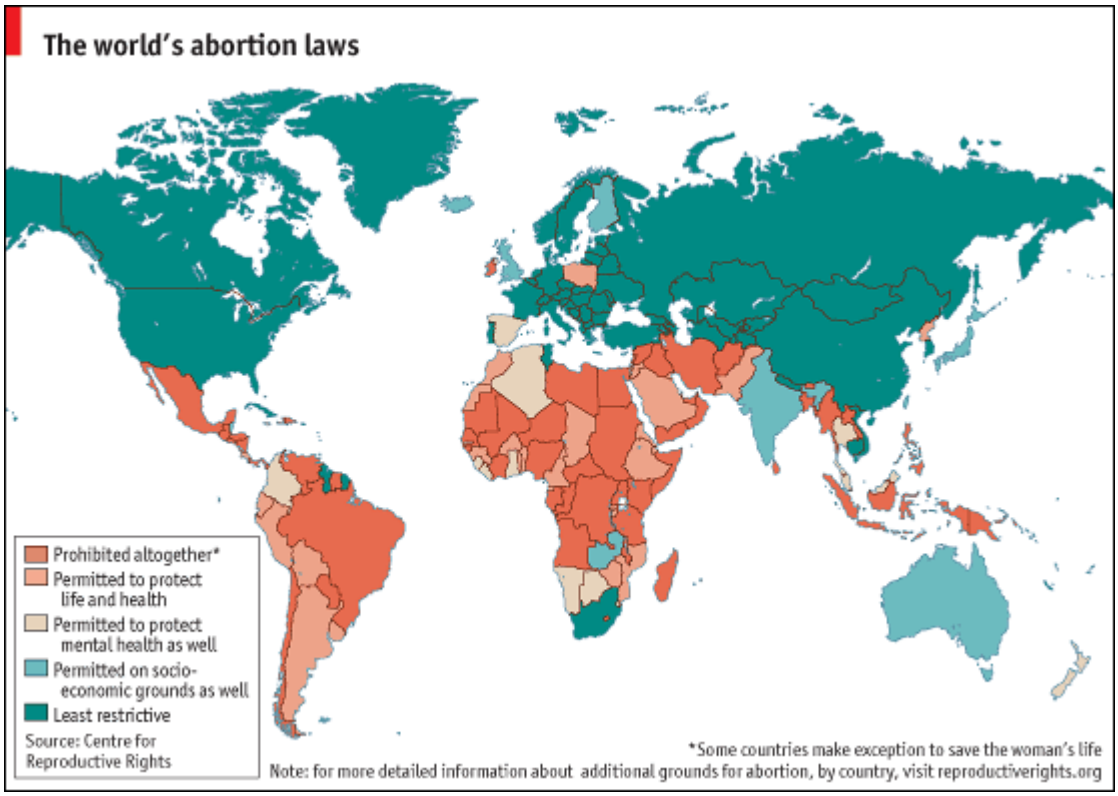
It is 12 years since the so-called Beijing Platform, signed by 189 states, urged a review of all laws that punish women for having abortions. Since then, 18 countries have made it easier for women to obtain a termination. But in at least four countries—America, Russia, Hungary and Poland—things have become more restrictive (with limits on the time, grounds or method), while another two, Nicaragua and El Salvador, have banned the practice outright. More than 50 countries now allow abortion virtually on

demand up to at least the 12th week of pregnancy; some (including Britain) permit it up to 24 weeks, and some (like parts of China) have no time limit.

But for those who agree with a formula coined by Bill Clinton—that abortion should be “safe, legal and rare”—the world is still far from ideal. Of a total of 46m abortions thought to be carried out each year (more than one in four pregnancies are terminated), some 20m are illegal, resulting in the death of around 70,000 women a year, according to the World Health Organisation. Abortion is either banned outright or is confined to cases of rape, incest or risk to the mother's life across most of the Muslim world, Catholic Latin America and Africa.

Although China reports 7m abortions a year (the real figure is much higher), it does not have the world's highest rate. That place is held by Romania, where some three-quarters of pregnancies are terminated (the same ratio as in New York City and Shanghai). Russia, the first country to allow abortion (in 1920), comes second with two in three pregnancies terminated. Rates are high across the former Soviet block, with the termination of more than one in two pregnancies in most countries.

In the United States, Australia, Canada, Britain and most of the rest of western Europe, around 15-25% of pregnancies are terminated. In India, an estimated 6.4m abortions take place every year (most involving female fetuses), representing one in four pregnancies. In many African and Muslim countries the rate is probably less than 5%, says William Robert Johnston, an American pundit. But he notes that data are elusive, and that the link between law and reality is often tenuous.



Indeed, some of the world's highest abortion rates are to be found in Latin America, where it is all but outlawed. The Mexican legislators who voted to decriminalise abortion cited the brutal effects of this gap between theory and practice: an estimated 5,000 women die in Latin America every year from botched back-street or self-administered abortions; a further 800,000 have to be treated in hospital.

In the same spirit, Brazil's new health minister has called for a “wide-ranging debate” on abortion, despite the opposition of two-thirds of Brazilians to any change. The pope's visit and the Mexican move have exposed strong feelings on both sides. Most Colombians, Mexicans and Chileans oppose legalising abortion. But in Argentina, where perhaps four in ten pregnancies are illegally ended, over 75% say it should be legal in some cases.

Like the Catholic church, Islam regards life as sacred from conception. But unlike the Vatican, Muslim thinkers tend to calibrate the gravity of the “sin” according to the timing—early abortions are viewed less seriously. Most Muslim countries outlaw the practice unless the mother's life is at risk; but Turkey and Tunisia allow abortion on demand during the first ten weeks or three months respectively.

In some countries, judges are stepping in. In May last year Colombia's Constitutional Court ruled that an outright ban on abortion was unconstitutional; it must be allowed in cases of rape, incest, severe deformity and danger to maternal health. In November, the Inter-American Commission on Human Rights said Nicaragua's total ban violated a woman's basic rights. And this March, the European Court of Human Rights ruled that governments must make it possible for women to have access to abortion, where it is legal.

As many states make abortion easier, America may be moving the other way. Last month the Supreme Court upheld a federal law, passed in 2003, banning “partial-birth” abortions, a late-term procedure involving the piercing of a fetus's skull. Some hope, and others fear, this could be a prelude to the overthrow of *Roe v Wade,* the 1973 ruling that has given America one of the strongest legal rights to abortion in the world. If that decision is quashed, abortion could be criminalised in about 30 states. Polls suggest that about half America's voters would approve.

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Political assassination

Regicide's risk

May 17th 2007
From The Economist print edition

Killing a leader doesn't always work

FRANZ FERDINAND found alive—first world war a mistake! Whoever wrote that graffiti must have shared the view that assassinations can change history. A new academic study* tries to analyse whether that impression is correct. It looks at 298 assassination attempts between 1875 and 2004, from the murder of Spain's Canovas in 1897 to that of Pakistan's General Zia in 1988.

The bad news for would-be Lee Harvey Oswalds is that the success rate is pretty poor. Only 59 of the 298 attempts resulted in the target's death, a hit rate of one in five. If you are planning to knock off a leader, it is far better to use a gun. Assassination attempts using firearms had a kill rate of around 30%, whereas those using bombs or other explosive devices worked only 7% of the time (but often harmed bystanders).

The good news for political leaders is that their chance of surviving office is improving. While the annual number of assassination attempts has been increasing (currently around one every two years), there are a lot more countries (and thus more leaders) than there were in the early 20th century. In the 1910s, a given leader had a 1% chance of being killed in any given year; today, the probability is around 0.3%.

Killing leaders does make a difference, but only in certain circumstances. Democracies seem to be able to cope with the loss of a president or prime minister. But in autocracies, a successful assassination was 13 percentage points more likely than a failed attempt to result in a transition to democracy. The "beneficial" impact of an autocrat's removal was still observable ten years later. However, given the low success rate of assassins, the gamble might not be worth it; autocrats who survived an attack tended to tighten their grip.

When it comes to wars, the effects are more subtle. Assassinations tend to hasten the end of intense wars (those with more than 1,000 battle deaths) but, prior to the second world war, made small-scale conflicts more intense. As for initiating conflicts, the academics find assassinations are irrelevant. So even if Franz Ferdinand had dodged the bullet, the first world war might have happened anyway.

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* "Hit or Miss? The Effect of Assassinations on Institutions and War" by Benjamin Jones, Northwestern University, and Benjamin Olken, Harvard University, CEPR discussion paper 6298.

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The alchemists of finance

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From The Economist print edition

Maria Jeeves

Global investment banks are taking ever more risk, and are devising ever more sophisticated ways of spreading it, says Henry Tricks (interviewed here). Is that reassuring or worrying?

AT LEAST since 1823, when Byron's Don Juan described “Jew Rothschild, and his fellow Christian Baring” as the “true Lords of Europe”, investment bankers have inspired awe, envy and, rightly or wrongly, a measure of disdain. Exactly 100 years ago the undisputed patriarch of the modern industry, J. Pierpont Morgan, stemmed the Panic of 1907, a financial crisis caused by unregulated trusts (the hedge funds of their day). Acting, in effect, as lender of last resort from his Wall Street office, he was briefly feted before Americans realised the danger of having such power vested in one man. Cartoonists then mercilessly mocked him. After his death in 1913 the Federal Reserve was set up.

The investment-banking industry was further constrained during the Depression of the 1930s, when Wall Street firms such as that founded by Morgan were split into commercial banks and securities houses. The latter—today's investment banks—underwrite stocks and bonds and advise companies on mergers and acquisitions, rather than collect deposits and make loans. In the 1980s and 1990s they developed a reputation for gluttonous excess. But a lot has changed since then.

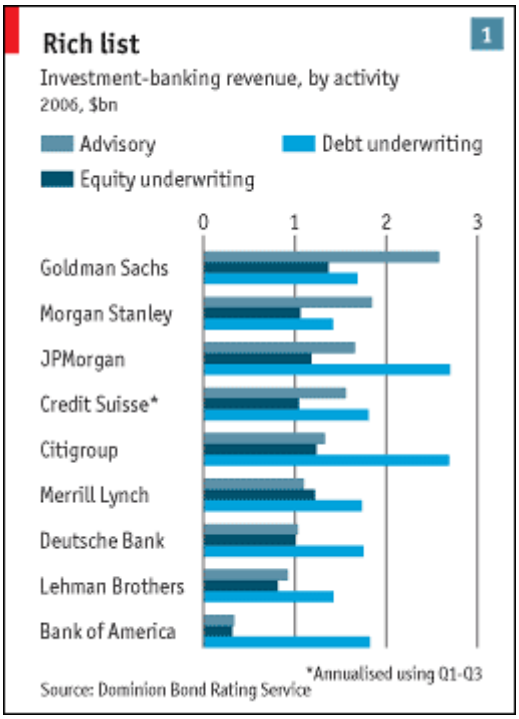
Intensely private partnerships have become publicly traded companies. Commercial banks such as Citigroup and JPMorgan Chase have muscled back into investment banking. And European warhorses such as Deutsche Bank, UBS and Credit Suisse have joined the race for global supremacy. The bets, and the profits, have got bigger, though investment banks are trying to keep quiet about that, for several reasons.

First, they are under more scrutiny. Wall Street firms had their wings clipped by Eliot Spitzer, New York's former attorney-general, for plugging worthless shares during the dotcom era. Being publicly traded companies has tamed some egos, too. Star traders do not enjoy the same headroom on salaries (albeit very large salaries) as they did when they were partners in the business. At UBS, a Swiss bank which in 2000 moved into the American equity markets by merging with PaineWebber, a brokerage, “fiefs” are explicitly banned. Richard Fuld, boss of Lehman Brothers, a fast-growing Wall Street firm, imposed a “one-firm culture” when it was spun off from American Express in 1994. Now, says Scott Freidheim, a top executive, Mr Fuld uses “culture” in speeches more often than any other word except “the”.

Meanwhile another group has overtaken the investment banks in the excess stakes: their money-spinning clients in the private-equity and hedge-fund industries. Already they throw the biggest parties, do the boldest deals and launch the most celebrated initial public offerings. The IPO of part of Blackstone,

a private-equity group, might well raise more money than Goldman Sachs's did in 1999, when even the company's doormen and drivers became extremely rich.

Yet when investment bankers discuss the fabulous fortunes accruing to these firms' founders, they do so without envy. “Theirs is a truly pioneering role,” says Anshu Jain, head of global markets at Deutsche Bank, one of the world's top trading banks. “Pioneers in any industry get a disproportionate share of the spoils.”



Even if they are no longer the pioneers, the investment banks have played a crucial part in bringing about the extraordinary changes seen in the financial markets, starting in the 1980s and accelerating dramatically in the past five years. Technology and innovation have brought unprecedented breadth, depth and richness to financial instruments. According to McKinsey, a consultancy, the stock of shares and public and private debt securities held in America grew from 2.4 times GDP in 1995 to 3.3 times in 2004. In Europe the increase was even more dramatic, albeit from a lower base. These figures do not include derivatives, notional amounts of which traded privately, or “over-the-counter” securities, which had soared to $370 trillion by last June, from $258 trillion less than two years earlier, according to the Bank for International Settlements (BIS). Given such torrid growth, the markets are becoming increasingly vital to global financial stability.

There have been thrills and spills along the way. The stockmarket crash of 1987 and the seizing up of credit markets after Russia defaulted in 1998 both exposed huge flaws in the industry, forcing central banks to step in to prevent what they feared might be lasting damage to the real economy. Even so, regulators reckon that on balance the growth of markets has been a good thing, making the financial system safer than more traditional forms of bank lending. The trouble is that given the complexity of the new instruments and the range of clients and countries involved, they can never be absolutely sure that a monumental crisis is not brewing somewhere.

What worries both bankers and regulators is not so much the threat from hedge funds or private-equity groups but the implications for the financial system of a possible collapse of an investment bank (or large complex financial institution, as they clumsily call it). At a time when America's housing market has exposed the danger of overexcitement on Wall Street, it is worth exploring how these institutions are evolving, how they handle the risks attached to what they do, and how well those risks are spread around the financial system. That is what this survey sets out to do.

Risk-takers Anonymous

Investment banking is in a state of evolution rather than revolution. The essence of the business has always been taking calculated (and sometimes miscalculated) risks. But now traders place bets in more places, with more clients and using more complicated gambling devices than ever before.

Brokerage used to be described as a haulage business, lugging money, as a member of the Rothschild dynasty once put it, “from point A, where it is, to point B, where it is needed”. The idea of describing themselves as glorified delivery men may well still appeal to the cynics on the trading floor who work with shirtsleeves rolled up and hail each other loudly in Brooklyn or mock cockney accents. But any haulage firm would be flabbergasted by the trading profits and returns on equity seen in investment banking in recent years, especially among Wall Street's big “bulge-bracket” firms. Svilen Ivanov, head of capital markets at Boston Consulting Group, notes that earnings from capital-market-related activities at the top ten global investment banks have risen by almost two-thirds in two years, from $55 billion in 2004 to $90 billion last year. That sort of profit increase is comparable with Apple's rewards for inventing the iPod, he points out. Yet in investment banking there is nothing nearly so tangible to which to ascribe the gains.

Bankers themselves are fuzzy about explaining their trading profits, bandying about phrases such as “deploying our intellectual capital”. But it is clear that three powerful forces are at work, all of them

overlapping and mutually reinforcing, and all fundamental to the gushing liquidity the world is currently enjoying.

The first is the alchemist's trick of turning debt (mostly leaden) into derivatives (mostly liquid); the second is the emergence of a new class of leveraged client (hedge funds and private equity); and the third is seeking out new capital markets, and clients, around the world. Moreover, in all these pursuits the firms are now using not just their clients' money but, to differing degrees, their own too.

Joseph Perella, an industry veteran who last year struck out independently with an advisory boutique, Perella Weinberg, observes that putting a firm's own capital into mergers, acquisitions and other transactions is one of the biggest changes in investment banking since the 1980s. “It's not just one firm sticking its neck out. It's across the board.”

But using the banks' own capital creates potential conflict. Not only do they risk putting their own interests before those of their clients; they are also increasingly exposing themselves to the dangers of an abrupt turn in the credit cycle. They are arranging ever bigger debt issues for private-equity firms and hedge funds and so are encouraging a borrowing binge that could breed financial instability. For the time being all this is hugely profitable. But it is also making the banks far too complacent for their own good.

The driving force behind all this has been an unusually benign economic climate. The global economy is at its least volatile since the 1960s, real interest rates are low and companies are generating huge profits. What some call “the great moderation” has been a boon to financial markets around the world, particularly those trading in the multifarious debt instruments concocted in the laboratories of Wall Street and the City of London. The opening up of Asian economies has brought down the price of traded goods, helping to fight inflation. Meanwhile, high savings rates in that part of the world, combined with ageing populations in the West, have helped to push up demand for long-term investment instruments such as bonds.

At the same time the search for yield, as investors seek to compensate for low returns in high-quality markets such as government bonds, has increased demand for instruments of greater complexity, such as credit-default swaps (CDSs), collateralised debt obligations (CDOs) and other derivatives. That has pushed down implied volatilities to multi-year lows, arguably making the assets appear more reassuring than they actually are.

Regulation has helped, too. Under the Basel 2 banking accord, whose trickier provisions are due to come into force in the European Union next January and in America starting a year later, capital will be allocated according to the riskiness of assets. That has encouraged banks to make more use of credit derivatives to diversify their credit portfolios, and to sell more assets into the capital markets to be repackaged into debt securities.

All of which means that investment banks have generated many of their trading profits from derivative trades—with each other, with their banking clients or with hedge funds which increasingly use the instruments as speculative tools. The demand for loans to repackage into securities, such as CDOs, has helped fuel the generous credit conditions that have underpinned private equity's leveraged buy-out (LBO) boom as well.

The wild east

To cap it all, over the past few years markets around the world have opened up in a way unmatched since before the first world war, and investment banks have seized the opportunity to expand internationally. Since the start of the 20th century, when America first emerged as an economic power, the world's financial-market activity had increasingly gravitated towards American share and bond markets. The introduction of the euro in 1999, and the rapid growth of economies in Europe and Asia, lured investment bankers in the other direction. The share of investment-banking fees earned from Europe was growing long before America's regulators woke up to the damage caused to American markets by aspects of the Sarbanes-Oxley act and other red tape. Last year, by some estimates, revenues from Europe and Asia overtook those from America for the first time (see chart 2).

In the meantime London has become an impressive rival to New York as a global financial centre. Michael Klein, the boss of corporate and investment banking at Citigroup, describes Britain's capital as New York, Chicago, Houston and Washington, DC,

rolled into one, because it trades all the assets of the first three and is regulated on the spot as well. Instead of Greenwich, Connecticut, it has Mayfair for hedge funds. London, moreover, is a hub for Europe, and stronger economies on the continent mean growing markets for capital; typically, such markets increase at double the rate of GDP when economies expand.

London's position as a springboard for emerging markets vastly increases its allure. America and Europe between them may still account for almost four-fifths of all investment-banking revenues, but fees are growing fastest in the developing world. That reflects the might of companies such as Gazprom, Russia's energy behemoth, and the recently listed Industrial and Commercial Bank of China, which Mr Klein admits are both vying with Citigroup in size. He notes that 140 of Citigroup's top 1,000 clients are from emerging markets, whereas 15 years ago the number was only 40. Russia and China are among the world's biggest IPO markets. And many developing countries are seeking to strengthen their domestic capital markets, which means that the biggest global investment banks—such as Citi—hope eventually to deploy enormous resources there: trading desks of perhaps 1,000 people, not 25.

Given the markets' increasing complexity, how do investment banks manage the growing risks they face? There are lots of things they need to do, from finding enough brainboxes capable of handling the intricate assets being created to measuring the correlations between instruments that are supposed to spread risk but may do the opposite if liquidity dries up. It is mildly reassuring that hardly a week goes by without regulators in the world's main markets pressing the industry to improve its risk-management techniques—but rather worrying that the same regulators pay considerably less attention to where the risk may end up.

Maria Jeeves

Investment bankers themselves have a vested interest in not blowing up their firms. The biggest banks are thought to be investing hundreds of millions of dollars a year in technologies to measure risk and stress-test it. Comfortingly, regulators who scrutinise the banks' risk-weighted capital say it is stronger than ever. But capital is only one line of defence. The banks' ability to cope with liquidity crises and credit crunches is harder to gauge.

Financial markets send out mixed messages about the confidence of investors in the institutions themselves. The investment banks' share prices appear to reflect the belief that their equity will be safeguarded rather than that earnings will be stable. As David Viniar, chief financial officer of Goldman Sachs, puts it, the firm, whose risk appetite is second to none, has increased revenues in 18 out of the past 21 years, but quarterly income has been more volatile. “It's a growth business and it's not going to get more stable,” he says.

Taking risks and managing them is an investment bank's core business. Bankers believe risk-taking is how their industry supports entrepreneurs and hence economic growth. The trouble is that new risks are almost invariably explored before there is a good way to measure them.

Ultimately, business and credit cycles tend to reveal which risks are excessive—and whatever junior traders may think, the business cycle is far from dead. Richard Portes, professor of economics at the London Business School, recalls first debating its possible demise back in 1969. Since then he has discovered a comment by Leon Fraser, an American banker, speaking after the great crash of 1929, which convinced him that boom-bust cycles in finance will always be with us. Mr Fraser's immortal words

were: “Better to have loaned and lost than never to have loaned at all.”

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Black boxes

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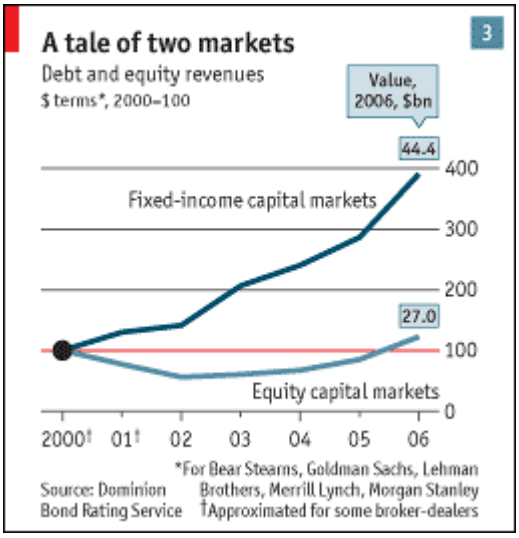
From The Economist print edition

Investment banks' inventions for transforming risk are ingenious, but hard to fathom

ADVANCES in technology and information have always been good for capital markets. Richard Sylla of New York University's Stern School of Business argues that financial globalisation started earlier than previously thought, around 1816. At that time packet sailing ships began to make regular scheduled crossings between New York and British ports, cutting the average time it took for mail—and information about securities prices—to cross the Atlantic. Later that century the telegraphic transatlantic cable, along with steam shipping, heralded the huge growth of global markets between 1870 and 1914.

The computer is the cable of our age, and it has turned investment banks into hothouses of financial innovation. The financial principles are not new: parallels have been drawn between the spectacular growth of credit derivatives in recent years and the introduction of wheat futures in America in the mid-19th century. But thanks to computing power the products have become infinitely more malleable. They are designed to appear complex and impenetrable. But they are not patented, and staff turnover across the investment-banking industry is estimated to be up to 20%, so ideas travel quickly. Margins fall, products go through the inevitable boom-and-bust cycle and the whole thing starts all over again.



The peephole into this mysterious world of debt is a single line in many investment banks' trading accounts known as FICC, for fixed income, currencies and commodities. For the five big Wall Street firms (Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns) taken together, these revenues have quadrupled since the start of this decade, according to Dominion Bond Rating Service, a rating agency (see chart 3). Back in 2000, when stockmarkets were booming, share-trading generated twice as much revenue as did fixed income. But it has been growing far more slowly, to only $27 billion last year, against $44 billion for fixed income.

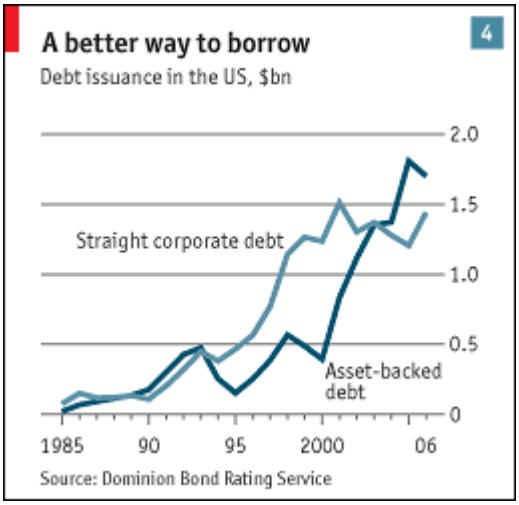
From copper to catastrophe

FICC encompasses a broad swathe of assets, from American subprime mortgages to Japanese yen, copper futures to catastrophe insurance, General Motors bonds to Zambian debt. Some of the fastest growth has been in tried-and-tested asset-backed securities such as commercial and residential mortgages, which have soared since 2000 whereas straight company debt issuance has stagnated (see chart 4). But the most profitable area has been the growth of derivative and structured credit products, such as CDSs and CDOs.

These have enabled banks to separate credit risk from interest rates and trade that risk among those who want to hold it and those who don't. This process has freed credit risk from the underlying bonds, leading to an explosion of secondary-market activity. For the banks it has been a goldmine, but for outsiders it is devilishly hard to know how much risk the new instruments entail.

The cornerstone of the new market is the CDS, a form of insurance contract linked to underlying debt that protects the buyer in case of default. The market has almost doubled in size every year for the past five years, reaching $20 trillion in notional

amounts outstanding last June, according to the Bank for International Settlements. That makes it far bigger than the underlying debt markets. Some 70% of these products are linked to an individual issuer and are not much more complex than selling a bond short. The fun starts with the other 30%. The mathematicians of Wall Street and London have found ways of bundling indexes of CDSs together and slicing them into tranches, based on riskiness and return. The most toxic tranche at the bottom exposes the holder to the first 3% of losses but also gives him a large portion of the returns. At the top, the risks and returns are much smaller—unless there is a systemic failure.



CDOs grew out of the market for asset-backed securities which took off in the 1970s and encompassed mortgages, credit-card receivables, car loans and even recording royalties. The structured CDO is a more complex variation, using lots more leverage and bundling bonds, loans and CDSs into securities that are sold in tranches. According to the Bond Market Association, an industry body, $489 billion-worth of CDOs were issued last year, twice the level in 2005. One-third were based on high-yield loans and are known as collateralised loan obligations (CLOs). The rest involved mortgage-backed securities, CDSs and even other CDOs (which become supertankers of leverage, known as CDO^2 and CDO^3).

Investment bankers are fascinated by the possibilities created by structured products, which they think offer almost limitless ways for their clients to manage risks. Some of the more ambitious are working on risk-transfer instruments that deal with weather, freight, emissions, mortality and longevity (see article). The most immediate opportunities, though, may be in asset classes—such as property derivatives—that have already proven successful in America but are still emerging in Europe and barely exist in developing countries.

Anshu Jain at Deutsche Bank says over half of the firm's trading profits last year came from this ill-defined area, which he loosely calls “intellectual capital”. About one-third of the business was done with hedge funds and the other two-thirds with financial institutions needing to match assets and liabilities, such as insurance companies. He believes that this aspect of trading may be less cyclical than other sources of revenue, such as proprietary positions.

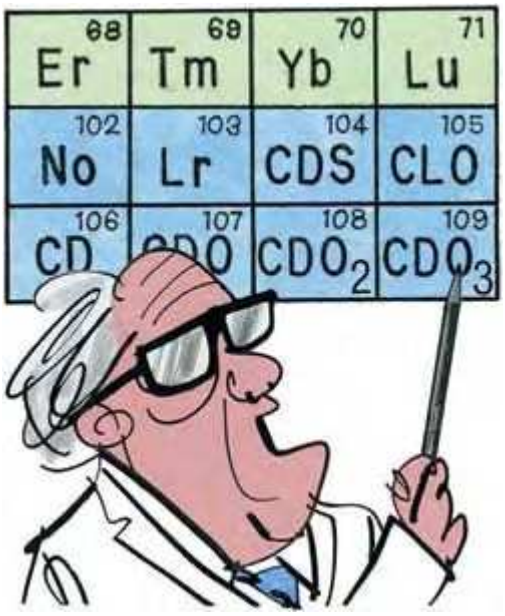
Matt King, a credit strategist at Citigroup, says that demand for CDOs has lately been stimulated by the approaching implementation of the Basel 2 capital accord, which encourages banks to swap risky loans on their books for CDO tranches to avoid high capital charges. This has been helped by the increasing willingness of banks to sell loans into the capital markets in order to diversify their portfolios. Huw van Steenis of Morgan Stanley estimates that some 78% of senior secured loans in America have now been sold in this way, compared with 29% in 1995. In Europe 53% are now securitised, up from 12% in 1999, still leaving considerable room for expansion. Alessandro Profumo, boss of UniCredit, a booming bank that has stitched together an investment-banking franchise across Italy, Germany, Austria and central and eastern Europe, says it sells €40 billion-50 billion ($54 billion-68 billion) of loans a year and would eventually like to make it a lot more.

Such financial innovation not only spreads the risk for investment banks' clients. It may also make the banks themselves more diversified as they search for the holy grail of finance: unrelated portfolios that do not all melt down at the same time. There is little correlation between credit and government bonds, for example. When credit spreads widen, investors flock to “safe haven” products such as government bonds.

Maria Jeeves

That is the theory, at least. But there are doubts, which may help explain the low multiples on investment banks' earnings. Guy Moszkowski, securities industry analyst at Merrill Lynch, describes the institutions as “black boxes”, revealing little about their overall exposures. A senior banker agrees. “There is a total lack of transparency. We make it impossible for our investors and analysts to understand what is going on.” He thinks that investors would be more impressed than scared if there were more disclosure, but accepts that it is difficult to reveal all unless competitors do the same.

Astronomical leverage



CDOs and CDSs generate other concerns too. One is the leverage embedded in them, which does not appear on banks' balance sheets. A senior European financial regulator draws particular attention to the way banks value deeply subordinated portions of CDOs. “They offer very attractive returns, but could fall off a cliff if something goes wrong,” he says. Lombard Street Research, a firm of economic analysts, calculates that such parts of a CDO might be geared up about nine times, and that the leverage will be many times greater still if a hedge fund has invested in them with borrowed money. The leverage becomes “astronomical”, the firm reckons, when the CDOs are based on other CDOs.

The second concern is the possible need to pay out on CDSs if a wave of defaults were to hit. The attraction for the CDS seller, as with any insurance contract, is receiving a steady stream of payments for a risk it hopes will not occur. If its calculations are wrong, the result can be devastating. The BIS says the best way to gauge the total volume of CDS exposures is by their gross market value, which was $294 billion last June. That is a small fraction of the $20 trillion in notional amounts outstanding, and the whole lot would never blow up at once. But there would still be tidy sums involved if the sellers—including investment banks—ever had to pay up.

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Les fleurs du mal

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From The Economist print edition

Exotic instruments are not for everyone

WHEN investment banks talked about exotic assets in the 1990s, they generally meant tiger-cub or puma economies such as Vietnam or Peru. Today the frontiers of finance involve anything from weather to mortality risk, from emissions to catastrophe insurance.

Now that technology and financial engineering have made it possible to isolate and trade all manner of risks, the insurance industry is marching ever more eagerly into the capital markets. Last year AXA, a French insurer, issued so-called mortality catastrophe bonds to protect itself in the event of large death tolls caused by, say, avian flu or terrorism. The bonds were put together by Swiss Re, a reinsurer, which had hired Jacques Aigrain, a former JPMorgan Chase investment banker, as its chief executive. It expects the market for insurance-backed bonds to leap from $25 billion now to at least $150 billion by 2015.

The investment banks are not standing idly by. ABN Amro, a Dutch bank now in a takeover battle, late last year led a collateralised debt obligation packaging the natural catastrophe risks of Catlin, a Bermuda-based insurer. Deutsche Bank is experimenting with markets in “event-loss swaps”—natural-disaster versions of the debt market's credit-default swaps. The risks of less unexpected deaths are also being packaged and traded. According to Fitch, a ratings agency, bonds linked to life insurance and mortality rates and sold to hedge and pension funds reached $5.4 billion last year, from next to nothing a few years ago.

So far, so ghoulish. But the principle could be extended to all walks of life. Perhaps farmers will be able to buy weather products at their local bank as a hedge against a poor harvest. Or emissions trading, which investment bankers love to discuss to display their green credentials, might become a vibrant global market.

Not so fast, says Tim Roberts, head of McKinsey's financial-institutions practice in London. This being a risk-taking business, investment bankers are naturally testing the boundaries. But it takes two to make a market, and many more to create a mass market. Hedge funds have emerged to hold some of the more exotic risks, perhaps waiting for markets to develop. Insurance products, unlike mortgages, are not standardised, says Mr Roberts. Even the mortgage-backed securities market in Europe has developed in fits and starts and has yet to be fully integrated. It takes time for legal frameworks and market infrastructures to adapt. Catastrophe bonds which offer protection against severe environmental shocks have been under discussion for at least a decade, explains Mr Roberts, but have only recently started to take off: “There's collective agreement that the capital markets have been slow to deliver to the insurance industry.”

For those who see themselves as pioneers in these new markets, there is an unhappy precedent. Charles Sanford, who from 1987 to 1996 was chairman of Bankers Trust, an American bank, was a visionary when it came to risk. He developed the concept of “particle finance” in which every form of risk could be isolated and sold to the buyer with the biggest appetite for it. But during his tenure Bankers Trust was hit by huge lawsuits over sales of derivatives, which it was forced to settle with clients such as Procter & Gamble. It never quite recovered its standing before eventually falling into the arms of Deutsche Bank in 1999.

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Capital spenders

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From The Economist print edition

Relentless competition is forcing financial firms to take more risks with their own capital

INVESTMENT bankers would hate to admit it, but traditionally they have borne some resemblance to estate agents, matching buyers and sellers of financial assets instead of houses and land and taking a fee on the transaction. Yet investment banks have recently changed out of all recognition. These days, if they were estate agents they would not only suggest a suitable property to buy and offer to handle the transaction but also propose a loan, come up with sophisticated products to offset the risk of rising rates, provide help with the down-payment, sell you funky insurance products and, if they decided the property was a bargain, even buy it from under your nose.

In short, investment banking has migrated from an agency model towards a principal one. The industry is not just offering its clients a growing array of products to buy and sell; it is making bigger bets with its own capital, too. According to Merrill Lynch, in 2005 one-third of the industry's revenues came from principal trading of debt and equity and only 15% from the commissions business, once the industry's bread and butter.

The main engine of transformation has been competition. Wall Street's sensitivity to charges that it operates as an underwriting oligopoly dates back at least to the Glass-Steagall act of 1933 when commercial banks were forced to sell or close their underwriting business, in effect reinforcing the franchises of "bulge-bracket" securities firms. But since the repeal of Glass-Steagall in 1999, commercial banks and investment banks have jumped onto each other's turf. JPMorgan, elbowed out of securities trading by Glass-Steagall (Morgan Stanley was carved out of the old House of Morgan to become the underwriting business), is now near the top of the global M&A league tables. Its market share has grown by about 50% since 2001, says Mr Moszkowski at Merrill Lynch.

Maria Jeeves

European universal banks such as UBS, Credit Suisse and Deutsche Bank, constrained by the lack of opportunities in their overbanked home markets, have also muscled into the American big league. UBS was one of the top share underwriters in America last year. Barclays Capital too, the investment-banking arm of the British bank, has successfully targeted America, concentrating on fixed-income products and commodities.

At the same time private-equity firms and hedge funds have mercilessly fished in Wall Street's talent pool. Some, such as Citadel, a hedge fund, have ventured into market-making in securities, an old Wall Street role. Others have gone for niche markets. Star-studded boutiques such as Greenhill and Perella Weinberg compete with banks in M&A. In trading, margins on cash equities, which used to be Wall Street's signature business, have been hit by electronic platforms and by rules to increase price transparency, such as Regulation National Market System (known as Reg NMS) in America.

The result, according to industry leaders, is growing pressure to explore new sources of profit. "I don't know an industry that is more competitive," says Lloyd Blankfein, boss of Goldman Sachs. "That is what is driving the innovation cycle."

The colour of their money

As commercial banks with trillion-dollar balance sheets compete with them for deals, the big five Wall Street securities firms are finding themselves under growing pressure to provide clients with financing as

well as advice. Advising on mergers and acquisitions is still the most profitable, and headline-grabbing, business on Wall Street (and Goldman remains top of the tree). Lending on deals offers lower margins if higher volumes. But, as Mr Blankfein puts it, “you have to offer advice and capital together.”

Citigroup, for example, claims to earn $5-8 from funding and other fees for every $1 it gets from advising clients on acquisitions. Thanks to debt underwriting, last year Citigroup and JPMorgan Chase bagged more investment-banking business than many of their Wall Street rivals. Those banks can rely on huge balance sheets, backed by cheap retail deposits, to make loans. The loans also give them recurring income to fall back on when market conditions worsen. Wall Street securities firms do not have access to such a stable supply of funding, so they have to raise capital in fickle markets instead.

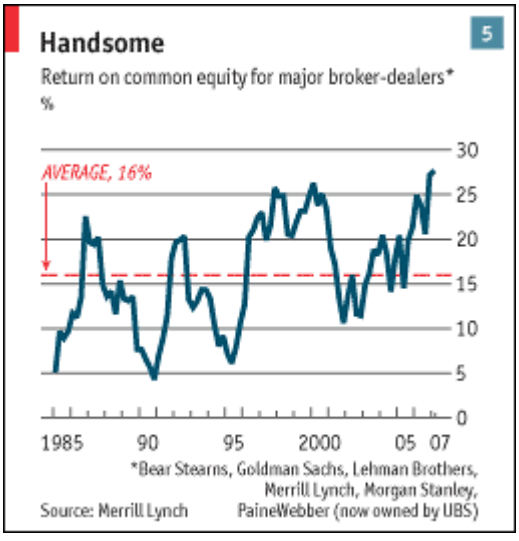
Still, they have found inventive ways to take on commercial banks at their own game. Goldman, for example, secured a backstop facility of at least $1 billion from Sumitomo Mitsui when it bought a stake in the Japanese bank in 2003. Merrill Lynch, Goldman and other Wall Street firms have acquired banking charters in America to gather deposits.

Owners beware

Increasingly the firms are buying their own investment assets too. For years they have been using proprietary trading desks to take positions. Now they have ventured into private equity as well, putting a growing proportion of their capital into long-term, illiquid investments, such as property or companies. Merrill Lynch, for example, holds a stake in Bloomberg, an information provider. Goldman has stakes in power plants across America, golf courses in Japan and a $5 billion stake in the vast Industrial and Commercial Bank of China. Brad Hintz of Bernstein Research notes that the share of the industry's capital held in such illiquid investments is growing very fast. At Merrill Lynch and Goldman they accounted for about half of the firms' equity capital last year, up from just over a quarter in 2005. That could be alarming if markets dry up and asset values plummet.

According to Dominion Bond Rating Service, all five Wall Street firms, Goldman, Merrill, Morgan Stanley, Lehman Brothers and Bear Stearns, almost doubled their equity capital between 2001 and 2006. Their assets grew just a tad faster, suggesting that they are expanding their businesses on firm foundations. Regulators have also had a clearer view of their capital since 2004 when their holding companies became Consolidated Supervised Entities, globally supervised by the Securities and Exchange Commission and subject to Basel Committee capital guidelines. Some of the supervisors believe their capital cushions are more substantial than they used to be.

There is no reason for complacency, however, because markets can respond in unpredictable ways, and nobody knows how severe such “tail events” could be. According to Timothy Geithner, president of the Federal Reserve Bank of New York, which keeps a close eye on Wall Street's exposures, “risk management is better and capital cushions are stronger than they were, relative to risk. But the banks are not invulnerable. We'd like to make sure that they're sufficiently strong to withstand adversity in the tail. The shape of the tail is very uncertain.”



Shareholders are not entirely sanguine either. Investment banks are mostly measured on their price-to-book value. Unlike the assets of a bank or an industrial company, most of the securities on their balance sheet have a book value that can be calculated daily and can be easily liquidated. That puts a floor under their price. Currently the big Wall Street firms are trading at more than twice their book value, reflecting last year's average returns on equity of about 25%, which is higher than their cost of capital. Their long-run average is 16% (see chart 5). Goldman, with a staggering 33% return on equity last year, has the highest valuation. But with so much more capital now deployed, the banks have to work harder to improve returns.

There is growing uncertainty about future earnings, however, pushing price-earnings multiples close to historic lows. This is partly because investment banking is a cyclical business, which may be peaking. It is also because their earnings are, to put it mildly, opaque. As Mr Hintz (a former chief financial officer of Lehman and treasurer of Morgan Stanley) candidly admits: “We can't be totally confident how they make

money trading or how sustainable trading is.”

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Merchants of boom

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From The Economist print edition

Advising on, financing and investing in buy-outs is a great business. But banks should not be too greedy

THE definition of merchant banking has changed many times over the centuries. Jews in medieval Italy, unrestrained by the Catholic ban on usury, advanced money at high interest rates to grain farmers to secure an option on their crops and then shipped the grain. One of the great investment banks of the 19th century, Barings, began life as a London outpost for the family's West Country wool business, operating as both merchant and banker. But it soon discovered that trading capital was a better way to get the attention of kings and emperors than shearing sheep.

Today Wall Street banks are once again investing large quantities of their own and their clients' capital in businesses, enjoying the same easy credit as their private-equity clients. They call it merchant banking, taking their cue from the grandfather of the industry, J. Pierpont Morgan, who created the world's first billion-dollar company in US Steel. Since the 1980s Wall Street has built up merchant banking in boom times, only to rue it bitterly afterwards. In the past three years acting as a principal has again become a big source of profit, and also of controversy, as banks try to negotiate the blurry line between advising clients, lending to them and pouring their own money into deals.

Advising companies in the S&P 500 and the FTSE 100 used to be the pinnacle of an investment banker's ambitions, and mergers and acquisitions among listed companies still account for 75-85% of global M&A volumes. But in the past three years private-equity firms have been lining the bankers' pockets. Freeman & Co, a New York consultancy, reckons that buy-out firms paid $12 billion to investment banks last year, more than three times as much as four years ago. The top private-equity fee-payer, Kohlberg Kravis Roberts (KKR), spent $783m. The top payer among the publicly listed companies, Xstrata, a global mining group, spent only $245m.

Nice little earner

A fringe benefit of advising on buy-outs is the invitation to invest in them. Here investment banks may use their own capital, as well as raising funds from outside investors in the hope of making money alongside their private-equity clients. Indeed the banks' own funds sometimes put those of their clients in the shade, though you rarely hear them trumpeting the fact. This year Goldman Sachs set itself the task of raising a mammoth $20 billion for its latest private-equity venture. It already has $145 billion of assets under management in its alternative investment funds, and $70 billion of committed equity capital in its merchant-banking arm.

Being one of the world's biggest private-equity funds, as well as one of the biggest advisers to them, could cause serious conflicts of interests. Goldman is likely to provide the third-biggest equity portion, behind TPG Capital and KKR, of the $45 billion bid for TXU, a Texas energy company. The TXU bid could become the biggest buy-out ever. At times it was hard to tell whether it was Goldman's deal or that of its clients.

Yet investment banks serve so many masters at the same time that sometimes they cannot avoid ruffling feathers. Goldman, along with other banks, has appointed senior people to prevent this happening or at least minimise the effects. “We can't avoid conflicts,” says the firm's Mr Viniar. “We have to manage them.”

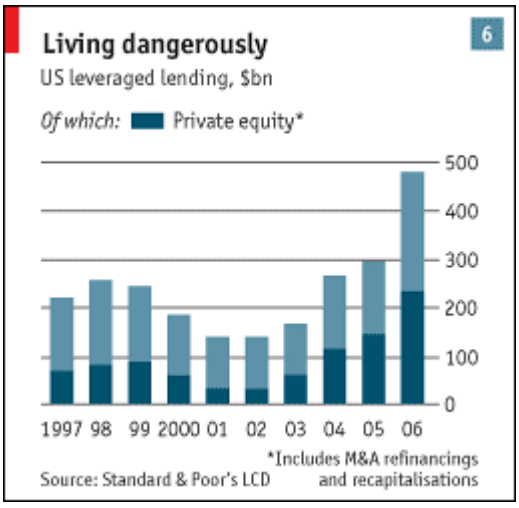
In 2004 Credit Suisse (then called CSFB) and JPMorgan Chase went head-to-head with private-equity paymasters such as TPG, KKR and Blackstone and won a $1.6 billion battle for Warner Chilcott, a British pharmaceuticals company. It proved a pyrrhic victory because it upset some of the banks' biggest clients. Unusually, one of them, TPG, aired its grievances in public.

But the most gripping action in private equity is in financing. The main funding tool of the buy-out boom

is what is known as leveraged lending: essentially, loans to borrowers with too much debt on their balance sheets to be judged as investment grade by rating agencies. In the heady days of the 1980s, leveraged buy-outs relied on junk bonds. But leveraged loans are now more popular than junk bonds, because they are quick to arrange and put a lender closer to the front of the repayment queue if the borrower runs into trouble.

According to Standard & Poor's LCD, a division of the rating agency, the first three months of 2007 were the busiest ever for the American leveraged-loan market. New loans totalled $183 billion, up 55% from the first quarter of 2006. The fastest growth came from private-equity groups, which raised $53 billion in three months, two-thirds more than a year earlier.

As in other parts of the debt markets, the liquidity has been fed by the large number of investors willing to buy tranches of collateralised debt obligations or, in the case of leveraged lending, collateralised loan obligations, a market which has rallied since 2002. Once bankers have underwritten the loans, they can sell them on to CLO funds rather than keeping them on their books, which may help to explain their willingness to take greater credit risks than before.



However, developments in the past year suggest that borrowers now call the shots and raise nagging concerns about underwriting standards. Buy-out firms have squeezed spreads on loans and bonds to levels that make bankers' eyes water. And despite the record investment pouring into private-equity funds, their principals have lately been passing round the hat among investment banks for “bridge equity” as well as bridge loans to do the largest deals.

For the first time, borrowers have also convinced banks to relax terms on covenants—the checks in place to make sure the issuer comes back to the table at the first sign of distress. Steve Miller, who tracks leveraged loans for S&P LCD, says that since the formation of the market in the 1980s, spreads and leverage have risen and fallen “like hemlines” and only covenants have remained constant.

But now, he says, new “covenant-lite” loans give borrowers rather greater latitude if their market sours. Such loans amounted to $48 billion in the first quarter, or one-third of the entire market, compared with just over 1% in 2005. He expects the covenant-lite market to slow, but still believes there has been a big relaxation of lending standards. As he puts it, this is “not your father's market, or your older sister's, for that matter”.

Regulators, too, have begun to express concern, seeing parallels, perhaps, with the over-optimism about the subprime mortgage market. “We are not entirely comfortable with the very high degrees of leverage in some company borrowing situations, such as private equity,” says Thomas Huertas of Britain's Financial Services Authority. “We take the old-fashioned view that the business cycle hasn't been repealed. When we see these types of deal structures it looks like the corporate equivalent of saying ‘house prices will always go up'.”

Bankers are not unaware of the risks they are running. As one senior financier in Europe confesses, “It's a bit like lending money to your children.” But the profits they can earn from the so-called triple play—advising on, financing and investing in buy-outs—make it hard to resist. Merrill Lynch, for example, reportedly earned $75m in fees for advising on the buy-out of HCA, an American hospital operator, helping to underwrite $22 billion in bank loans. It also took a $1.5 billion equity stake.

But the banks would be wise to look back on recent history. The exuberant junk-bond era of the 1980s, when high-yielding debt securities fuelled a wave of takeovers, ended with the bankruptcy in 1990 of Drexel Burnham Lambert, which had dominated the market. During the following decade, banks such as Chase Manhattan formed venture-capital arms to invest in technology start-ups. They lost heavily when the tech bubble burst.

Perceived conflicts of interest have led some investment banks to give private equity a wide berth. JPMorgan Chase, UBS, Deutsche Bank and Morgan Stanley have all retreated from merchant banking in the past half-decade, a move which some of their bankers now rue bitterly—but may eventually give thanks for.

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Share-cropping

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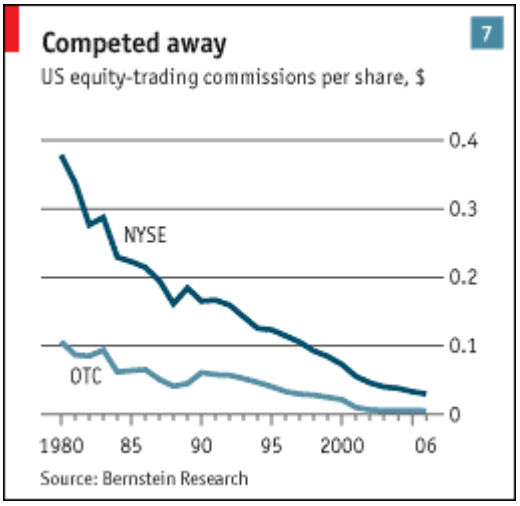
From The Economist print edition

Hard-hit equity traders are fighting back

IT IS not just in the debt markets that risks are being divided into their component parts. The equities business, too, is splitting the financial atom. The profitability of share-trading by large investors, which used to be at the heart of brokerage, has fallen since the collapse of the dotcom boom. The old system, in which brokers provided money managers with research as well as orders, in exchange for plump commissions, has been overtaken by electronic transactions in which shares are processed cheaply in vast shoals. Since 2003 the 20-year decline in commissions at the largest firms has been accelerating (see chart 7). Firms have weathered the storm because of a pick-up in equity underwriting, which is highly profitable. But when the cycle turns, equities trading and research will need to change. Big wallets and sharp wits will be needed to survive.

The biggest clients, such as mutual funds, did themselves a lot of damage with their lemming-like behaviour during the internet bubble, and are exposed to competition on many fronts. Hedge funds are chipping away at their business, charging high fees in exchange for the promise (often unkept) of performance above stockmarket benchmarks. Cheaper index-linked products such as exchange-traded funds have also undercut the money-management business. Mutual funds, in turn, have taken their troubles out on brokers, squeezing trading costs even lower.



As commissions have fallen, hedge funds have helped ease the pain for the brokers. They turn over share portfolios so quickly that they partially make up in increased volume what dealers lose from lower fees on each trade. Hedge funds have also developed lucrative prime-broking relationships with a trio of investment banks that moved into the business early—Morgan Stanley, Goldman Sachs and Bear Stearns—borrowing money and shares from them and often paying a lot for advice. But the profitability of the prime-brokerage business has attracted many other investment banks: Lehman Brothers, Merrill Lynch and Deutsche Bank are all energetic late entrants. Mr Hintz of Bernstein Research reckons this may have brought down prime-brokerage returns for all.

The increasingly clear divide between active investments—those that attempt to beat the market—and passive investments, which attempt to track it, is also changing the business. For example, the mutual-fund industry is becoming split between dirt-cheap algorithmic index-tracking and higher-margin products that either include hedge funds or try to emulate them.

One of the fastest-growing segments is 130/30 funds, which borrow heavily from the long/short hedge-fund model. Merrill Lynch estimates that assets under management in such funds total about $50 billion. Besides making it possible to carry long-only positions (a bet that selected stocks will rise), they also allow 30% of long stocks to be leveraged and 30% to be sold short (or borrowed and sold on the assumption that the price will go down). This type of fund requires greater stock-picking skills from a manager than a plain variety and commands much higher fees. It is also subject to the law that not everyone can beat the market all the time.

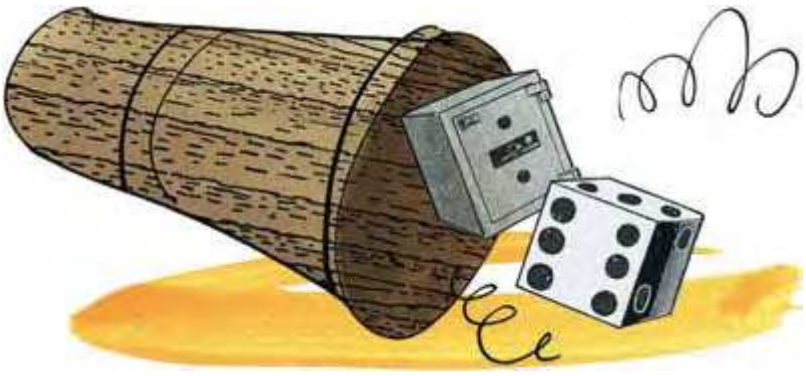
Brokers go for broke

Brokers, for their part, are also putting more of their capital into supporting their own and their clients' equity punts, ie, acting as principals rather than agents. Equity derivatives are flourishing, which means brokers are increasingly making their own leveraged bets in order to write hedging contracts for clients. Rohit D'Souza, head of global equities at Merrill Lynch, describes this as “providing capital to support our

clients' ideas”—much as his fixed-income counterpart would.

On top of this, proprietary risk-taking is increasing. According to Mr Hintz, Wall Street's equity-related value at risk (VAR), which estimates the amount it could lose in a short period if markets fell sharply, has soared from about $80m in 2002 to upwards of $140m last year. Somewhat reassuringly, profits appear to be rising faster than the VAR. Clients, however, worry that their ideas could at best be copied, at worst used against them, by the proprietary-trading desks. Some of this, such as “front-running” (a broker trading on its own account before executing orders submitted earlier by the customer), is illegal, but is thought to go on all the same.

Maria Jeeves



Their excesses during the dotcom boom are coming to haunt equity traders. America's Regulation National Market System and the European Union's Markets in Financial Instruments Directive (MiFID) will require brokers to pursue the best possible deals for clients rather than automatically funnel them through their own systems. This has already produced quite a flurry of rival electronic platforms offering low prices.

Analysis of companies, too, is under pressure. In America research was split off from investment banking in 2003, with painful effects. Mr Hintz reckons research budgets on Wall Street fell by a third between 2000 and 2005. In London regulators are forcing banks to disentangle the cost of research from the cost of trading, which leaves many wondering how analysts will pay for themselves.

Who needs research?

But there is a fighting spirit in the research departments, just as there is on the trading floors. Candace Browning, head of global research at Merrill Lynch, displayed it in March with a letter to clients complaining bitterly that research was being “Napsterised” (referring to Napster, the website that pioneered free music downloads). She condemned the “never-ending litany” of statements predicting the demise of research carried out by investment banks, and vowed to deny non-clients access to such research.

In fact, investment-banking research departments do have a future. Like trading desks, they have to become more bespoke, catering to hedge funds and others who want ideas that will generate fast profits. But they will live and die by their quality, not by the big names of their employers. If their independence is compromised, as it so often has been in the past, there are plenty of up-and-coming boutiques to steal their clients from them.

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Here, there and everywhere

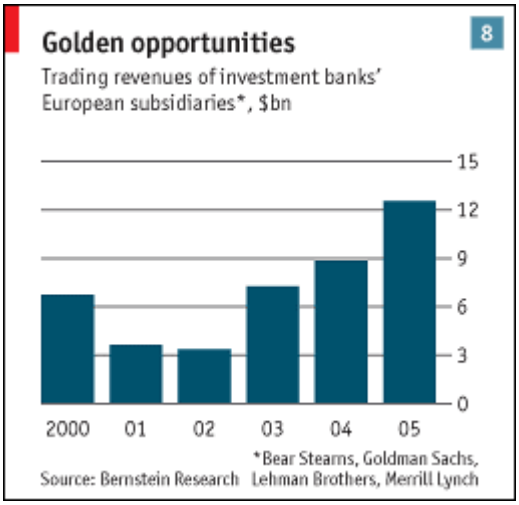
May 17th 2007
From The Economist print edition

Investment banks are scouring the globe for new business

MAKE the mistake of describing Goldman Sachs as “sort of a global bank” to Lloyd Blankfein, its boss, and you get a thundering response: “Sort of! What do you mean, sort of?”

Empire-building is as important to investment banks today as it was to their forebears more than a century ago, when Citibank had offices from Mexico City to Manila and Deutsche Bank financed railways from the Wild West to Baghdad. As in that earlier era, capital now moves effortlessly across time-zones, political systems and asset classes. Within the past decade Europe's single currency has taken root and China and India have grown flush with capital, as have oil exporters such as Russia and the Gulf states. Japan, too, has begun to emerge from a decade of stagnation. America, meanwhile, has wrapped up its own financial markets in red tape and may be losing its hegemony.

Huw van Steenis at Morgan Stanley in London estimates that securities markets outside America are expanding three times faster than those within, which they overtook in size in the first half of 2006. The pace of debt and share issuance in Europe since 2002 has easily outstripped that in America. Since 2005 volumes of mergers and acquisitions outside America have been larger than inside. And revenues of the biggest Wall Street banks' subsidiaries generated from trading in Europe have doubled since 2000 (see chart 8).



Yet there is room for further growth. McKinsey calculates that in 1995 the outstanding stock of debt and equity securities in the future euro-zone countries was 1.3 times the size of their collective GDP. By 2004 it had grown to 2.4 times. But it still fell short of America's, where the capital markets were more than triple the size of the economy. Investment banks' sales and trading revenues in Europe still represent only 50-60% of those in America.

Gregory Fleming, the ebullient head of markets and investment banking at Merrill Lynch in New York, predicts that in perhaps only seven years' time up to 75% of his firm's global markets and investment-banking revenues may come from outside America, compared with 50% now. “This is not because of a lack of growth in this country. It is more because of growth of economies around the world,” he says. “For the first time there is a broad-based global financial system.”

Next stop the N11

Having already occupied Europe, the top ten investment banks have set their sights on the rest of the world, too. Almost all of them are now increasingly involved in the so-called BRIC economies, Brazil, Russia, India and China. Next in line may be some of those Goldman has dubbed the N11 (for next 11); in alphabetical order, Bangladesh, Egypt, Indonesia, Iran, South Korea, Mexico, Nigeria, Pakistan, the Philippines, Turkey and Vietnam.

Banks have travelled these trade routes before in moments of global bullishness, probably once a decade, only to retreat hastily after some emerging-market crisis. But this time they believe it will be different. They are not just seeking to sell cheap emerging-markets assets to investors from the rich world. The developing world, with big, commodity-rich companies and surplus savings looking for safe returns, is itself shopping in the West for everything from Treasury bonds to wax museums and steel plants.

The abundance of petrodollars and hard-currency reserves is one reason why the world is awash with liquidity and long-term interest rates are low. But many emerging markets have lower domestic borrowing costs too, thanks to investment-grade debt ratings and nascent domestic capital markets. Mr Klein of Citigroup notes that it now costs the same to borrow overnight from a bank in China as from one in Germany. “The last remaining wall separating emerging markets from developed markets, the cost of capital, has been almost eliminated in the past four years,” he says.

As a result, large developing-country companies with global ambitions, such as China's CNOOC, Russia's Gazprom or India's Tata Steel, can get access to international finance as readily as their counterparts from the rich world. That means investment banks have to deploy more staff on the ground to find out what these firms are up to. “These are large, highly complex companies with increasingly complicated needs. To really understand a company like Gazprom requires more than just an occasional visit from head office,” explains Jonathan Chenevix-Trench, chairman of Morgan Stanley International.

Putting down roots

But what is the best way to tackle global expansion? Citigroup, for example, has offices in 106 countries and can afford to deploy lots of staff. For the first time this year it has put large emerging-market companies under the leadership of a single global corporate bank. It is also betting heavily on stronger domestic markets in countries such as Russia and China. Its philosophy, says Mr Klein, is “when you enter a country, you don't leave.”

The philosophy of pure investment banks, such as Morgan Stanley, is changing too. “Banks used to take a cyclical approach to emerging markets, investing when assets were cheap. When there was trouble, they would sell,” says Mr Chenevix-Trench. “Now it's not a matter of trading assets in these countries, it's a matter of building businesses.”

To underline these new priorities, the lifts in Morgan Stanley's headquarters in London's Canary Wharf display posters about the firm's growing involvement in the Middle East. The firm has moved 40 bankers to Dubai, and has recently signed a joint venture with the Capital Group in Saudi Arabia, where it acts mainly as an intermediary for the region's vast wealth. In Russia, where it has a bigger presence, dating back to before the dark days of 1998, it is targeting not just initial public offerings and acquisitions but also a growing domestic market. Last year securities trading in Russia rose by over 60%, it estimates.

Morgan Stanley is also one of many banks excited by talk of a resource-rich “great crescent” stretching from Russia through Central Asia to North Africa. The optimists—of whom there are many in investment banking—believe this region could eventually provide the equivalent of another Germany to capital-markets revenues. McKinsey expects the share of petrodollar-related revenues in the industry to grow between 9% and 15% in a decade. The potential pitfalls, however, are huge, especially in Russia, where the rulebooks are new and untested and talent is so hard to come by that the best people shuttle between global and local banks.

Maria Jeeves

Caution is indeed warranted. Credit Suisse lost $1.3 billion after Russia defaulted on its domestic debt in 1998, and Merrill Lynch sacked staff just after the default (only to re-hire them months later when the markets proved more resilient than it had expected). Earlier this year Merrill secured a broking licence in Moscow, but has moved cautiously.

Many investment banks expanding in emerging markets have trouble finding local people whom they can trust to maintain the firm's risk-management culture. This has become all the more important because investment banks are increasingly devolving risk-taking responsibility to regional hubs and even local offices. Risk management is following.

“As recently as five years ago, Merrill Lynch had a New York-centric operating model with a lot of global products managed from here,” says Mr Fleming. This is changing. Banks now tend to believe that the closer they are to their markets, the better they are able to assess the risks.

Lehman Brothers is also actively considering decentralisation, says Jeremy Isaacs, its chief executive in London. Until now the people running its main global divisions have been based in New York. But in early May the firm announced that the new head of its global fixed-income business would be working from London.

The region that probably has a greater variety of local peculiarities than anywhere else—and where investment-banking revenues have grown fastest recently—is Asia.

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The art of courtship

May 17th 2007
From The Economist print edition

In Asia, banks have to try harder

"IN THIS part of the world relationship is everything," says a seasoned British banker in Hong Kong. UBS, a Swiss bank, has learned that lesson too. In 2002 it helped the Chinese government with a landmark initial public offering for Bank of China in Hong Kong. At about the same time it worked with China to design a quota system allowing foreign banks limited rights to trade Chinese shares (and won the first quota). And it employs Leon Brittan, the former European Union commissioner who negotiated China's entry into the World Trade Organisation, to take tea with the country's leaders in Beijing.

These attentions paid off earlier this year when UBS won permission to take control of its joint-venture partner, Beijing Securities. If everything goes as planned, that will make it the only foreign bank besides Goldman Sachs to manage underwriting in the local market. Morgan Stanley has a 34% stake in China International Capital Corp, which was the top share underwriter last year, but it is a passive one. Other banks keen to establish joint ventures in China's brokerage industry will have to wait, because China has stopped issuing new licences.

Goldman, too, has practised the art of courtship. Hank Paulson, now America's treasury secretary, is said to have visited China at least 70 times when he was the firm's chief executive. There is a lot at stake. A senior UBS manager acknowledges that his firm could be called upon to help bail out other brokers if something went wrong. But both UBS and Goldman are undoubtedly delighted to be firmly ensconced in China as their rivals watch in envy. For China is arguably the most important prize as investment banks scramble back into Asia, putting the mishaps of the late 1990s behind them.

According to Freeman & Co, investment banking fees from Asia grew at 18% a year between 2001 and 2006, faster than in Europe and three times as fast as in America. Growth was strongest in India, rising by 47% a year from a low base, but the fee pool in China and its region was almost the size of Japan's, which has a much larger domestic market (see chart 9). Most firms predict that double-digit revenue growth will continue across the region in the next few years.

A strategy for Asia is more complex to design than for Europe or America. The financial systems across the region are at vastly different stages of maturity and there is a bewildering array of regulations, legal systems and compliance requirements. In Hong Kong and Singapore, for example, investment banks trade everything from foreign-exchange futures to credit derivatives and structured products. South Korea has become one of the world's biggest markets for warrants in the few years since it started trading in equity derivatives. India has a vibrant local stockmarket and sophisticated retail investors, but currency and other controls make it a frustrating place for international brokers.

China, as ever, blows hot and cold. Curiously, at present more investment-banking revenues come from Taiwan than from the mainland, though China's are growing faster, says Lehman Brothers. The value of the Chinese stockmarket tops $1 trillion, but after a huge run-up at the start of this year the market fell when officials sought to calm down overexcited retail investors. The regulatory environment in Beijing is hard to gauge and enforcement of securities law is haphazard. Bankers say local brokers have often misused clients' funds.

Watch it grow

But there are plenty of reasons for risk-takers to salivate over the region. Australia provides the second-largest source of fees in the region after Japan, according to Lehman Brothers. It is also replete with private-equity money (much of it on the rebound after a rebuff from China). Hong Kong and Singapore compete to attract hedge funds. Some banks have made fortunes from pouring private-equity-style capital into the region. Goldman earned $5.2 billion from a small stake in the Industrial and Commercial Bank of China, which issued a record-breaking $22 billion-worth of new shares last year; Merrill Lynch and the Royal Bank of Scotland tripled their money from investing in Bank of China. Liquidity is abundant because the region saves so much. Yet no bank has established a fully integrated investment-banking model in Asia, which means all comers have a chance to make their mark.

Merrill Lynch believes India may be the land of greatest opportunity in the near term, judging China more of an IPO prospect (the bank was lead bookrunner for the ICBC flotation, which paid it handsomely). Last year it paid $500m to raise its stake in DSP, a leading Indian broker, to 90%. Goldman and Morgan Stanley have abandoned their Indian joint ventures because regulations have eased, believing they can do better on their own there. Citigroup and UBS, among others, have successfully entered alone. All want to book a bigger share of investment-banking revenues that have risen tenfold since 2002. The spoils have not been divided evenly, however: local brokers have dropped down the league tables. None of them advised on Tata Steel's takeover last year of Corus, an Anglo-Dutch steel company.

China is likely to keep a careful eye on the experience of India's domestic brokers. As the head of a top global investment bank in China puts it, the authorities are prepared to see a securities market that is less than fully Chinese, “just not a predominantly foreign one”. They want to retain control to stop markets becoming too volatile and threatening domestic stability. A compliant domestic brokerage base is easier to steer than the thundering herd from Wall Street and Europe.

Many instruments still cannot be traded in China. Currency controls impede all manner of things that could be useful to Chinese firms. Hedging is extremely difficult. For banks such as Morgan Stanley, which has acquired a local licence by buying a small bank, each new product it hopes to sell requires a separate stamp of approval, which can take months. And because local banks still account for almost all domestic lending, there is no securitisation of bank loans.

Yet even with such constraints, there are plenty of ways for banks to make money in China. IPOs are the biggest, and even if the giant listings of recent years are close to exhausted, there are still mid-market firms needing to raise capital. China's vast corporate underbelly contains lots of growing companies that are not yet ready for public markets but are prepared to offer bold investors long-term stakes through private placements. Such issues are handled quietly, but a banker says hedge funds in Hong Kong are mopping them up.

Some bankers believe that the keenest foreign firms may have got a little ahead of themselves. “It's like kids going to the sweet shop for the first time,” says a long-time Hong Kong banker. Others are playing a waiting game. JPMorgan Chase, for example, appears to believe that at a weaker point in the economic cycle it will find opportunities to make a decisive move into China. Not all are wholly sympathetic to Mr Paulson who, in response to mounting congressional pressure against China's trade surplus, is urging the country to free up the capital markets. Some, such as Robert Morrice, chief executive of Barclays Capital in Asia, note a lack of reciprocity in the West in granting access to emerging-market banks.

Clearly there will be setbacks in Asia. Last year Merrill led the underwriting of a bond issue for a government-owned Thai bank launched hours before the military coup. After a debate about whether to exercise the bond's *force majeure* clause, the issue was repriced and relaunched.

Getting the risk management right is one of the reasons why banks like UBS prefer to have full control of operations in the region. But Peter Wuffli, the bank's chief executive, argues that diversification matters most and can improve stability over time. When regulators express concern about the bank's growing exposure to far-flung places, he has the perfect riposte. What business has lost UBS the most money in recent history? Not emerging markets, he says, but lending on property in Switzerland in the late 1980s.

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Comeback kid

May 17th 2007
From The Economist print edition

Maria Jeeves

After two decades in the wilderness, Japan is slowly returning to the international financial scene

WHEN Yuji Yamamoto, Japan's minister for financial services, recently announced his intention to revive Tokyo as a world financial centre, expatriate bankers could hardly suppress a smile. It has been almost 20 years since Japanese financial institutions flashed their capital around New York and London, and since then the balance of power has shifted dramatically.

Sumitomo Bank, which in 1986 rattled Wall Street by buying a slice of Goldman Sachs, is now part of a bigger group, Sumitomo Mitsui Banking Corp (SMBC), in which the *surippa* is on the other foot: Goldman is a big investor. Bankers in Japan complain that the locals have become insular in financial matters—the legacy of years when cash-strapped banks stopped sending their staff abroad and teaching them English. The country is a regulatory quagmire. Japanese authorities require more paperwork than does the rest of Asia put together, says a banker.

Most poignantly, while Japan was absorbed with its economic slump and bad-loan problems in the 1990s, Hong Kong and Singapore emerged as English-speaking Asian trading hubs with light regulation, lower taxes and, peripatetic bankers note, a less gruelling journey between airport and office. “These are brave words,” one foreign banker says of Mr Yamamoto's plans. “But Tokyo has lost a lot of time.”

International investment banks have not sat idly by. The recovery of Japan's equity markets, the profits from converting non-performing loans into investments such as golf courses and property, and trading in the oceanic government-bond market have made it a good place to do business in recent years, but a frustrating one nonetheless.

The bane of cheap credit

Last year capital-market fees paid to investment banks as a proportion of GDP were only one-third the level in America and half the level in Europe, bankers say. Japan's share of the global equity market has shrunk from over a third in 1990 to a puny one-tenth. One of the main reasons, says Mark Branson, chief executive of UBS Securities Japan, is that the local commercial banks continue to lend at very low rates to their business customers. As he puts it: “Cheap credit has been the dead hand on the capital market.”

The banking crisis and economic slump of the 1990s may have erased some of the most familiar names of Japan's glory days of banking, but they have not wiped out all the old habits. Three megabanks have emerged from a wave of mergers and takeovers: Mizuho, formed in 2000, SMBC, hatched a year later, and the biggest, Mitsubishi-UFJ, created in 2005. But they have retained some of their old practices of relationship lending, and are only just beginning to make use of capital-markets products.

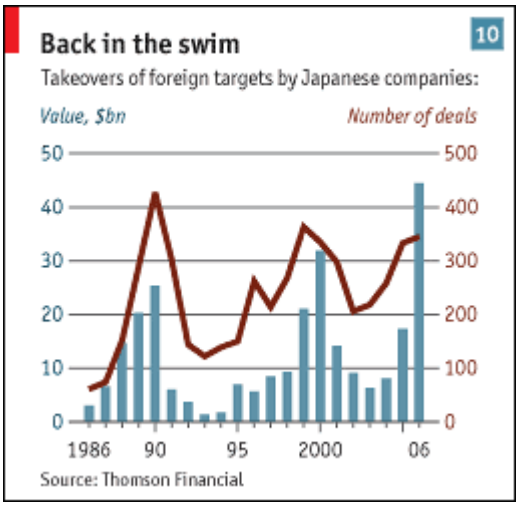
“The lesson we learned in the past decade was that our loan books were very concentrated on property.

We need more diversification, which means developing a syndicated-loan market and a risk-hedging market. We paid a high price to learn that lesson," says Katsuyuki Hasegawa, senior economist at the Mizuho Research Institute. His figures show that in 2005 Japanese companies for the first time in a decade borrowed more than they repaid. However, last year two-thirds of their borrowing needs were met by bank loans, compared with just 19% in America, where the capital markets are much more liquid.

The market for syndicated loans is growing by about 15% a year, says Mr Hasegawa. The securitisation market is expanding almost twice as fast; Wall Street firms such as Morgan Stanley and Lehman Brothers have bought regional banks to gain access to their mortgage loans. Yet the debt markets remain backward, and Mr Hasegawa says they operate inefficiently: changing jobs, for example, can make it much harder for an applicant to get a mortgage, even if he is going to a more senior and better-paid post.

Another problem is the requirement for strict firewalls between corporate and investment banks. This dates back to the period after the second world war when Japan imported rules from America, including a version of the 1933 Glass-Steagall act, separating the activities of commercial banks and securities firms. America scrapped Glass-Steagall in 1999, but Article 65, as the Japanese law is known, remains on the books. Lenders and investment bankers are unable to share information on a client unless the client gives permission. This adds another layer of cost to investment banking in Japan. And regulation is unpredictable. "You're always feeling your way," says one banker.

Given the cheaper and easier opportunities elsewhere in Asia, there are plenty of reasons not to allocate more investment-banking resources to Japan. But there are quite a few encouraging signs too. Japan Tobacco's acquisition of Gallaher, its British equivalent, was one of many recent overseas conquests: last year the value of outbound M&A from Japan exceeded that of the bubble years of 1990 and 2000 (see chart 10). Foreign investors now hold a quarter of Japanese shares and are shaking up corporate governance. In 2000 Ripplewood faced strong opposition when it rescued what became Shinsei bank, but the deal proved hugely profitable and other private-equity groups have managed to elbow their way into deals. And league-table rankings last year were fairly evenly shared between the top three global investment banks, Citigroup, UBS and Goldman Sachs, and the local brokers, Nomura, Daiwa and Mizuho.



Mr Yamamoto is thought to be in favour of a more liquid market for capital in which local as well as international firms can thrive, but he is up against powerful vested interests. So bankers were impressed when regulators did nothing to stop Citigroup's $7.7 billion acquisition of Nikko Cordial, owner of the third-largest Japanese broker by revenue (even though Nikko had been tainted by a recent administrative scandal). That was a sign of openness that anyone, Japanese- or English-speaking, could understand.

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The wobble factor

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Regulators are doing their best to ensure financial stability, but they don't have all the answers

IN 2005 participants at the Kansas City Fed's annual shindig in Jackson Hole, Wyoming, were reminded of a sunny day in London in June 2000 when the queen opened the new Millennium Bridge. Thousands of people flocked to take part in the spectacle, but no sooner had they stepped on to the bridge than it started shaking violently, forcing them to hold on to the handrails. The bridge was immediately closed again and remained so for 18 months.

The speaker at Jackson Hole, Hyun Song Shin, a professor of economics at Princeton University, used that embarrassing wobble as a metaphor for potential instability in financial markets. He was discussing a paper entitled “Has Financial Development Made the World Riskier?”, and he equated the pedestrians on the bridge to people in financial markets, and the bridge itself to movements in prices.

As Mr Shin observed, soldiers are trained to break step before crossing bridges. The footfall of thousands of individuals should be entirely random in the first place. “Here is the catch,” he said. “When the bridge moves, everyone adjusts his or her stance at the same time. This synchronised movement pushes the bridge that the people are standing on, and makes it move even more. This, in turn, makes the people adjust their stance more drastically, and so on. In other words, the wobble of the bridge feeds on itself.”

Fears of a self-reinforcing downward spiral in prices have been around for as long as financial markets have, but regulators and central bankers are becoming more vocal about the danger. The proliferation of new instruments, such as credit derivatives, and new market participants, such as hedge funds, intermediated by a small number of large global investment banks, poses new questions about financial stability. The “professional pessimists”, as some bankers call regulators, concede that under benign economic conditions everything appears to be working remarkably well. But how bad will the wobble be when conditions get worse?

It is clear that new forces are at work. The big investment banks' exposure to privately arranged credit derivatives is estimated to be nearly as large as to their more traditional forms of lending. Hedge funds early last year accounted for more than half of all credit-derivative transactions. Commercial banks have sold off loans and bought structured credit products instead.

These three factors have fed more liquidity into the capital markets, and credit spreads have fallen dramatically. The paradox, as Malcolm Knight, general manager of the BIS, put it in a speech in February to the Global Association of Risk Professionals, is that financial markets may be vulnerable to the same forces that triggered old-fashioned bank runs. And if there is a run, hedge funds, whose assets under management have tripled this decade to about $1.5 trillion, may drain liquidity rather than provide it.

Maria Jeeves

Safety catches

The industry has tried to deal with these concerns. In 2005 some of the world's most senior bankers, led by Gerald Corrigan, a former head of the New York Fed now at Goldman Sachs, issued a comprehensive report that looked at financial stability from a private-sector perspective. This differentiated between “disturbances” (isolated problems) and “shocks” (systemic ones). It identified three “red zone” shocks: the emerging-markets debt crisis of the mid-1980s; the stockmarket crash of 1987; and the Asian and

Russian crises culminating in the near-collapse of Long-Term Capital Management, a hugely over-leveraged hedge fund, in 1998.

To help prevent further shocks, the group produced guidelines on which regulators are still chewing today. The most important of these include identifying credit risk, liquidity risk, crowded trades, embedded leverage in complex instruments, the shortcomings of financial modelling techniques and unexpected “tail risks”.

The most basic rule, say regulators, is “know your counterparty”. Banks are being discouraged from doing business with hedge funds that reveal little about their exposures or risk-management systems, and to strengthen collateral requirements where there are doubts. This is especially important when hedge funds have exposure to many banks, so lenders are not sure where they stand in the repayment queue.

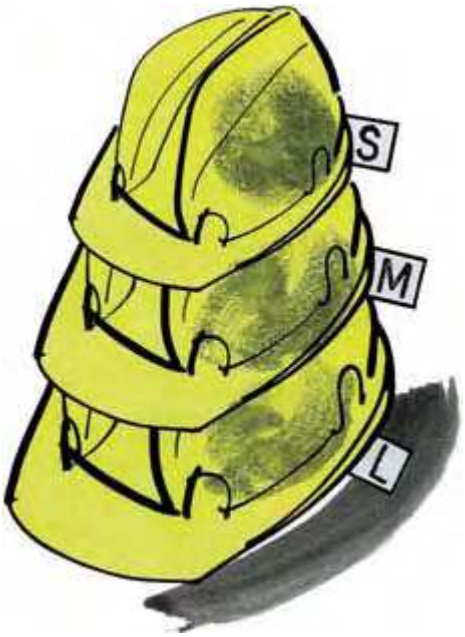
But even with the best checks and balances in place, collateral can be a double-edged sword. As Mr Geithner of the New York Fed puts it, in periods of stress, as firms move to hedge against future losses and to raise money for margin calls, “the brake becomes the accelerator.” It can exacerbate the wobble.

Banks should not be complacent about their financial models, either. Prices of new instruments, by definition, have short histories, which makes it hard to predict how they will react in a crisis. At the height of the troubles with subprime mortgages earlier this year the price of indices based on tranches of subprime loans went into free fall. Regulators are now asking whether that was modelled for.

Sorting out a crisis once it has occurred will also present new headaches. With risk held by so many new market participants, it is not clear how easily they could be corralled to deal with a large default. And even where banks know there are shortcomings in the market infrastructure for new assets, they may not do anything about it individually for fear of losing business to rivals. For example, the industry used to take a long time to settle CDS trades. It was only after regulators in New York and London twisted its arm that, collectively, it agreed to mend its ways.

Regulators say the investment banks have got much better at dealing with the risks, though there is room for further improvement. Annette Nazareth, a commissioner at America's Securities and Exchange Commission (which supervises investment banks), says there are “rumblings” that non-American banks trying to build up their prime-brokerage arms, through which they supply hedge funds with credit and other facilities, may be offering lenient credit terms. John Dugan, head of the Office of the Comptroller of the Currency, which oversees the largest commercial banks in America, says there has been some slippage in the collateral demanded from hedge funds. But, he notes, “our banks owe them more money than they owe us. This is a function of financial-market conditions and credit terms, and because both of these variables can change we have to remain vigilant.”

Maria Jeeves



Many hope that when the Basel 2 capital accord is introduced in Europe and (eventually) in America, it will further strengthen risk-management systems in respect of new instruments and trading partners. The accord updates the one-size-fits-all framework of Basel 1, dating back to 1988, when capital requirements were set on parameters now considered unsatisfactory. For example, banks had to post the same amount of capital against lending to IBM as to an internet start-up. Under Basel 2, capital requirements will depend on the rating of a borrower and the type of loan. Sometimes banks will also be able to use their own assessments of capital needs.

Some aspects of the new regime require extensive discussion between banks and their supervisors on how to assess complex credit exposures. Capital also has to be set aside against operating losses, which for large investment banks exposed to complex transactions may be onerous.

Not everybody agrees that Basel 2 has all the answers. Sheila Bair, chairman of America's Federal Deposit Insurance Corporation, which provides a safety net for bank depositors, worries that the models it uses to assess risk-weighted capital have been designed in a period of unprecedented prosperity for the banks. That may lead to insufficient levels of capital when the credit cycle deteriorates. “I'd rather

maintain a constant cushion of capital in good times and bad," she says.

The accord does maintain minimum capital requirements and allows plenty of scope for fine-tuning. But, as Ms Bair points out, with banks potentially holding much less capital during business expansions under the new rules, raising the capital they will need to withstand a recession could be painful and risk a credit crunch.

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Eggheads and long tails

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Investment banks are a high-wire act. How good are the safety nets?

BANKERS can be surprisingly colourful when describing the risks that keep them, their shareholders and their supervisors awake at night. One Spaniard likens the financial system to a “spider's web” over which central banks have less control than they did in the past; another talks about a “constellation” of risks and approaching asteroids. A French banker refers to a “soufflé” of off-balance-sheet exposures, whipped up by leverage. A British counterpart, speaking over breakfast, compares the process of transferring risk around the financial system to spreading butter on toast. With luck, he says, the butter will not be rancid.

Mr Isaacs at Lehman Brothers in London notes that over the past century of world wars and cold wars the financial system has proved more resilient than might have been expected. Like many bankers, he thinks that the biggest danger to the financial system at present is avian flu. But he agrees that there are new difficulties in managing a system where risk is transferred from banks to investors. Other bankers point out that although investment banks may have fewer loans on their balance sheets, they now carry more complex exposures, such as collateralised lending to hedge funds.

Risk, though spread far more widely, has not disappeared. In a crisis such exposures may surface in ways that are hard to predict, especially because so many banks are exposed to the same counterparties. “The risk is disseminated, but trying to re-aggregate it becomes an almost impossible task,” says one senior investment banker.

Banks are not helpless in the face of such uncertainty. One of the landmark changes of the past 20 years has been the development of risk-management systems that estimate potential market, credit, liquidity and operational losses and seek to impose appropriate limits. Investment banks, because of the complexity of their exposures, have been at the forefront of efforts to measure and manage risks, encouraged further by the approach of Basel 2. They have employed mathematicians and spent billions of dollars on computer systems. Barclays Capital has turned whole walls into whiteboards to accommodate the hugely complex formulas involved. But the results of all this effort are not quite as brilliant as might have been hoped.

The bond-market turmoil leading to the liquidation of Long-Term Capital Management (LTCM) in the summer of 1998 not only exposed the risk-management negligence of that institution, staffed by Nobel laureates and storied traders; many investment banks were caught out too. The lesson, learned at an exorbitant cost, was that models are only as good as what is fed into them. So risk management is as much about human judgment as about mathematical genius.

And there is always the million-to-one chance, far along one tail of the bell curve, that something will go disastrously wrong. There is a parallel here with climate change, where many previous sceptics are now in favour of taking preventive action—not so much because they think the world could not cope with the most widely expected rise in temperature, but because they fear that things might just possibly turn out very much worse.

Thinking the unthinkable

An assessment of the investment banks' risk-management systems must start from the premise that as they have grown, and diversified their sources of revenue, they should be less exposed to losses capable of wiping out the firm. That, after all, is the point of diversification.

Also, trading floors now pay much more attention to risk management than they used to, and although there are inevitable tensions between risk-takers and risk-controllers, almost everyone appears to take the issue seriously.

But because risk management has become so complex, understanding the systems in place even in one

bank could take days. Those who have tried, such as Moody's Investors Service, are impressed with the progress made by Wall Street banks, though they think that levels of disclosure are higher among some of the big European banks. They have also found a fascinating mixture of risk-management methodologies which provide a rare glimpse into the internal culture of these secretive organisations.

In a report last year Moody's looked at Goldman Sachs, the most profitable investment bank and, in many respects, the envy of its peers. Describing its risk philosophy, Moody's said Goldman saw risk not only as the counterpart to revenues or profit, but as “the source of profit”. According to Moody's, “most firms might ask themselves if they are taking too much risk; Goldman Sachs's most senior management—more aggressively than others—constantly asks the question, 'are we taking too little?' and 'are we taking the right kind of risks?'”

In its annual report Goldman says that all risk-control functions ultimately report to the management committee (though, in common with other Wall Street firms, not to the board of directors). The checks and balances then cascade down to the level of each trading-desk head, the front-line where decisions to buy and sell are made almost instantly. The main tool for assessing the short-term losses traders are exposed to is value at risk (VAR). Goldman, for example, would expect to lose more than its VAR in the course of a single day about once a month. Last year its daily VAR averaged $101m, against $70m in 2005. But VAR is clumsy, relies on historical data and works best when markets are stable. It does not capture the effects of highly stressed markets, nor what would happen if assets could not be quickly hedged or liquidated.

What bankers use for those things are stress tests. According to Moody's, the overall assumption behind Goldman's scenario planning is that the firm is unable to hedge or sell positions and must hold them from peak to trough. One of its fixed-income tests is a replay of the 1998 LTCM and bond-market meltdown. In its equity division it uses a “supercrash test” that assumes an instantaneous fall in the price of equities of 50%. The Armageddon experiment combines the worst that has happened in both fixed-income and equity markets over the past 30 years. Besides market risks, Goldman also assesses credit risks, based on whether a counterparty might default on a loan or fail to honour a derivative contract, and liquidity risk. But the firm does not disclose much detail on any of its simulations, nor do most other banks. France's Société Générale is an honourable exception.

Moody's is impressed by many of Goldman's techniques. Although the risks have increased, the ability to generate earnings has gone up even more. But the rating agency also has concerns, both about Goldman and about its Wall Street peers. It worries about the opacity, the exposure to illiquid investments and the failure to spell out worst-case scenarios. Goldman has large, illiquid off-balance-sheet exposures, too, known as Variable Interest Entities. These include pools of debt securities such as mortgages. Last year these assets surged to $72.5 billion from $54.1 billion, and Goldman's maximum exposure to loss from them doubled to $20 billion.

Mr Viniar, the firm's chief financial officer, acknowledges that the models cannot be perfect: “We know with 100% certainty that we can't know everything.” But the main backstop, what he calls “the lifeblood of Goldman Sachs”, is liquidity. He thinks that liquidity problems are the main source of risk in investment banking. They brought down Drexel Burnham Lambert in 1990 and Barings five years later. Goldman keeps $50 billion-60 billion of government securities ready to be deployed if a liquidity crisis strikes. The amount increases in proportion to the firm's assets and capital. And Goldman finances all its long-term illiquid assets with long-term debt and equity.

Simmering pots

The universal banks conduct their risk management along similar lines to Wall Street. But there are differences in methodology, and in each firm's risk appetite. Credit Suisse and UBS, two Swiss banks, are among the most forthcoming with their risk-management assessments.

Wilson Ervin, Credit Suisse's chief risk officer, appropriately works in a building that is a living testament

to risk. Credit Suisse's New York headquarters, at 11 Madison Avenue, was intended to be the world's tallest building when Metropolitan Life started work on it in the 1920s. But the 1929 stockmarket crash put an end to that ambition and construction stopped at 28 floors. That is how the tower has remained to this day, stubby but stunning.

Mr Ervin is ready to clamp down on exposures that might dent the bank's balance sheet or earnings, but most of his job involves “watching the pots simmering”. He says it is important to concentrate on good information and clear rules, not to micromanage the decisions of traders and credit officers. However, he notes that risk appetites are changing across the industry, especially in the use of investment banks' own capital to support private-equity transactions. “Things we used to say were *verboten* are now considered an acceptable risk-return trade-off as liquidity and hedging markets have developed.”

Maria Jeeves

Credit Suisse's rival, UBS, can hardly forget the risk-management failure of its predecessor, Union Bank of Switzerland. It made disastrous investments in the late 1990s, including in LTCM, and was taken over, in tatters, by Swiss Bank Corp. Now, as at Credit Suisse, risk is managed at the top of the bank. Responsibility is delegated by the board of directors to Walter Stuerzinger, group chief risk officer.

Mr Stuerzinger describes UBS's approach to risk in stark terms: zero tolerance for fiefs; beware of tail risks, risk concentrations, illiquid risks and legacies; avoid risks that cannot be properly assessed or limited; and never be hostage to a single transaction or client. UBS sets its overall risk capacity on the basis that it wants to be able to pay dividends out of current earnings, not retained ones. But thanks to earnings growth and the divestment of its private-equity portfolio, its ability to take risks has grown much faster than its actual risk exposure. Indeed, it is sometimes criticised for not taking large enough punts. Earlier this year Ken Moelis, an investment banker prominent on Wall Street, left the firm, reportedly because he felt it was too conservative in using its own capital in private-equity deals.

A question of culture

In the end, for all the fancy technologies, it is culture that counts. This boils down to the people a firm employs, the responsibilities it gives them and the way it rewards them for putting the company's interests above their own. One well-established technique is to give them shares in the company, which can make up a large part of their pay. Some Wall Street firms maintain a partnership culture even after they have gone public. Goldman, for example, has a “partnership pool” into which a large share of its profits go.

Given the rapid staff turnover at investment banks, keeping the firms' “culture carriers” on board is a perennial problem. The best way is to pay them generously. But success is also a powerful incentive, so employees need to be allowed to take risks and not be stifled with controls. That may mean giving ambitious twenty-somethings their heads. Mr Blankfein at Goldman acknowledges that some of the young traders at the firm have no memory of a business cycle. Clearly he does, but he says he respects their views and has not been disappointed so far.

Above those traders are wiser heads who should be prepared to extend a restraining hand. Between them, the 21 members of Goldman's management committee have 300 years of experience within the firm. Yet even that massed experience cannot guarantee that they will always be able to keep trouble at

bay.

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Spreading the muck

May 17th 2007
From The Economist print edition

Maria Jeeves

Is risk ending up in the right places?

“MONEY is like muck,” wrote Francis Bacon in 1625. “Not good except it be spread.” Today's pin-striped philosophers might swap the word “money” for “risk”. Hold credit risk too long, Wall Street wisdom has it, and it may eventually reek to high heaven. Spread it about, and a hundred flowers of finance will bloom.

It is at least 20 years since such theories began to take root in the world of banking, and there are good reasons why commercial banks that make loans, and investment banks that transform them into securities, have embraced them. Regulation allows banks to hold less capital if they lend to sound and diverse borrowers, so better to sell off the dodgier stuff if they can. The more of their lumpish loans that are converted into liquid securities, the higher the profits that accrue to the middlemen, the investment banks. And regulators too are happier if the banks whose depositors they are meant to be safeguarding have less toxic matter on their books.

But where does that risk end up? And might some of it be sitting undetected on the books of investment banks, the most complex institutions at the centre of the finely spun web of global finance? This survey has sought to test the nuts and bolts of their risk-management machinery to see how solid they are. What it has found is partially reassuring. The top firms trade in such a large number of products, markets and countries that they appear to be better cushioned than ever against problems arising in any one part of their business. Competition—whether caused by the demise of Glass-Steagall in America, the emergence of strong universal banks in Europe or boutique firms such as hedge funds poaching their best people—has sharpened their wits. They are taking more risk, but then risk is their business. Earnings and capital have risen even faster. And they are trying to expect the unexpected, aware of the inherent flaws in the models they use to measure their increasingly complex exposures.

Good times can't last for ever

But with money so cheap and liquidity so plentiful, the investment banks have inevitably become a little complacent. Their willingness to rush headlong into subprime mortgage lending in America is a case in point. As one European central banker puts it: “With all the sophistication of their risk-management systems, a whole series of the most powerful institutions in finance went ahead and made the classic errors of not watching credit quality and overshooting.” And their flair for creating complex instruments in which leverage and collateral are finely balanced may backfire on them—as well as on the industry at large—when big risks resurface and they rush for “safe haven” products. As the BIS's Mr Knight deftly puts it, the trouble with risk is that “now you see it, now you don't.”

Regulators also judge the soundness of the financial system in terms of the safety of individual banks. For all their misgivings, they generally applaud the improvements they have seen in investment banks

and in risk management across the financial system as a whole.

But what of the end-users—the pension funds managing the accounts of individuals, who are often beyond the regulators' remit yet may be increasingly exposed to these tail risks? Are they expert enough to assess the soundness of the loans they invest in? Are they as savvy as banks, whose core business is managing risk, and which have close and possibly long-standing relationships with the borrowers?

Avinash Persaud, head of Intelligence Capital, a firm of financial advisers, and an expert on systemic risk, says a new culture has grown up in which risk has become a hot potato, to be passed on as rapidly as possible. Increasingly it is ending up in obscure and unregulated corners. The financial system, he says, has “become better at trading risk and pricing it, but maybe worse at holding it”. Pension funds, for example, currently have an appetite for company loans and bonds. Is that a good thing? Mr Persaud thinks not, because they are long-term investors—and the longer an investor holds a bond, the higher the chance that it will default. Neither should they go after liquid assets: most of their liabilities are long-term, and therefore better suited to higher-yielding illiquid ones.

He believes such concerns have become more serious now that pension providers and governments are increasingly transferring responsibility for risk-taking to individuals, through defined-contribution pension schemes rather than defined-benefit ones in which companies supposedly bear the risk. Jaime Caruana, head of capital markets at the International Monetary Fund, strikes a pessimistic note. “It is not easy to know where all the risks are distributed. But some of them are ending up with the consumer who is taking on the role of shock absorber of last resort. We need to increase his level of financial education so that the consumer better understands what he is taking on.”

When *The Economist* published a report similar to this one exactly 20 years ago, much of the argument concentrated on the risks posed by securitisation and the proliferation of new instruments, such as (back then) junk bonds and swaps. At the time, Alexandre Lamfalussy, one of Mr Knight's predecessors at the BIS, aired concerns that now sound eerily familiar. “It's not the risk to individual banks I'm worried about but macro-prudential risk...it is much harder to tell who is bearing what risk and where it is ending up.” He continued: “Transparency is diminishing. Some risk-takers simply do not know the risk.”

It is encouraging that in the intervening two decades, when the capital markets have increased hugely in size, scope and sophistication, only two big shocks, one in 1987 (proving Mr Lamfalussy right) and one in 1998, have put the system to the test. For much of that period the markets have enjoyed easy money and lashings of liquidity. When those halcyon days come to an end, it will be not just the bright young things in Wall Street and Canary Wharf who will feel the effects, but widows, orphans, pensioners and everybody else.

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Chrysler

Divorced

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Getty Images

What the sale of Chrysler to a private-equity firm means for America's car industry

Get article background

IT WAS billed as a “merger of equals”, but in the end the participants could not make a go of it and their marriage failed. The break-up announced this week of DaimlerChrysler, a transatlantic carmaker created by the union of Daimler-Benz and Chrysler in 1998, involves the sale of 80.1% of Chrysler to Cerberus Capital Management, a private-equity group, for $7.4 billion—though once everything is accounted for, Cerberus is actually being paid to take the troubled American carmaker off the hands of the German company, which will be renamed Daimler.

Hopes were high back in November 1998 when Jürgen Schrempp and Bob Eaton, briefly co-chairmen of DaimlerChrysler, rang the bell at the New York Stock Exchange to announce the start of trading in their company. Mr Schrempp saw the $36 billion acquisition of Chrysler as the foundation of a global alliance that would, he hoped, include tie-ups with Hyundai of South Korea and Mitsubishi of Japan, among others. But his scheme failed and the merger foundered.

His successor, Dieter Zetsche, who took over in 2006, was reluctant to abandon Chrysler. The moustachioed and charismatic executive had engineered its brief turnaround during his five-year tenure as its boss, starting in 2000. That the revival did not last long was true to form for Chrysler, which has veered between profit and loss ever since it was established by Walter P. Chrysler in 1924.

Today's woes were triggered in large part by last year's soaring petrol prices in America, which is still Chrysler's most important market. Motorists turned their backs on the gas-guzzling pickups and sport-utility vehicles that account for roughly two-thirds of Chrysler's sales. The firm initially ignored the problem and continued to churn out vehicles, storing them in car parks around Detroit and selling them at low prices to car-rental firms. As losses mounted, DaimlerChrysler had to cook up yet another turnaround plan. In February Tom LaSorda, Chrysler's boss, ordered what would become known as the “St Valentine's Day massacre”. His plan called for the loss of 13,000 jobs, the closing of an assembly line in Newark, Delaware, and cuts at other factories.

But it was not enough for the German side of the company, which had never really warmed to Chrysler. Efforts to link product development at Chrysler and Mercedes-Benz always met with fierce resistance. “It was just like two independent companies simply added together their numbers on the balance sheet, and not much else,” says David Healy, an analyst at Burnham Securities, a brokerage. When Mr Zetsche conceded in February that “all options are on the table” it was clear that the marriage was doomed. Potential suitors immediately lined up, and in recent weeks it seemed that Magna, a Canadian parts firm, had emerged as the favourite.

Cerberus clinched the deal, however, mainly because of the speed and certainty with which it will be able to complete the transaction. Daimler will retain a 19.9% stake in Chrysler once the deal closes later this year. The transaction will leave the new Chrysler debt-free. Just over $6 billion of Cerberus's investment will go into the new company. Daimler will cover outstanding debts, grant a $400m loan to the new firm and absorb Chrysler's losses until the sale is completed. This will wipe out the $1.35 billion it will receive from Cerberus, so that it is, in effect, likely to end up paying $670m or so to get rid of Chrysler.

Spot the difference

Why does Cerberus think it can succeed in turning Chrysler around, given that Daimler failed? It has several answers. For one thing, the new company should end up with a BB debt rating, which will reduce its borrowing costs. The injection of cash from Cerberus will give it greater room for manoeuvre as it restructures itself than is available to its cash-strapped American rivals, General Motors (GM) and Ford. And John Snow, a former American treasury secretary and Cerberus's chairman, contends that Chrysler will be far better off as a private company and will be able to take a longer-term view once freed from the need to report quarterly results.

Surprisingly, despite its reputation as an axe-wielding, job-slashing cost-cutter, Cerberus is not, so far, talking about more job losses: it says it plans to stick to Mr LaSorda's turnaround plan, and has asked him to stay on to implement it. (He will be joined by Wolfgang Bernhard, Chrysler's former number two, who recently left VW and has been acting as an adviser to Cerberus.) There may be cross-selling and cost-cutting opportunities between Chrysler's finance arm and GMAC, GM's financial-services arm, in which a consortium led by Cerberus bought a 51% stake last year. But most speculation centres on Chrysler's health-care liabilities, estimated at some $18 billion, which the new firm will assume under this week's deal.

Industry insiders are betting that Cerberus will press the UAW to accept a health-care deal along the lines of that agreed in December by Goodyear, a tyremaker. That scheme offloaded the management of health-care liabilities to a fund run by the tyremaker's union, unburdening the company. Given that the UAW endorsed the sale to Cerberus this week, some speculate that the outlines of such a deal have already been agreed upon.

If such a deal were to be struck between the UAW and Chrysler, GM and Ford would demand something similar. A Goodyear-style deal “might actually be good for the UAW, and give it a raison d'être,” suggests a senior executive at a supplier in Detroit. (The union's membership has declined sharply in the past two decades.) The sale of Chrysler to Cerberus might, in short, lead to an improvement in the fortunes of America's top two carmakers—not just the number three.

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Health care

From clipboards to keyboards

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America's health-care industry has been slow to adopt information technology

“PAPER kills,” Newt Gingrich likes to say these days. America's former House speaker points to Hurricane Katrina, after which many survivors suffered needlessly or died because their paper records had washed away. But the lucky few whose doctors had been wired up could retrieve electronic medical records (EMRs) nationwide. An official in New Orleans puts it bluntly: “Katrina taught us that America has to change its health-information systems immediately.”

The health-care sector in North America spends surprisingly little on information technology (IT). The financial-services industry spends about $200 billion a year on high-tech kit; health providers spend just over a tenth of that amount (see chart). But John-David Lovelock of Gartner, a market-research firm, predicts that IT spending in health care will increase by an average of 4.7% per year between 2005 to 2010, the fastest growth-rate of any industry and well above the average of 3.7%.

Technology firms sense the coming bonanza, judging by the mood at a gathering of health-care experts held in New York on May 15th and hosted by Jeffrey Immelt, the chairman of GE. Joseph Hogan, the head of GE's health-care division, declared that “technology will be at the heart of fixing the health-care crisis.” A spokesman for Siemens, a German rival, argued that the “explosion of medical knowledge” from the field of genomics means that information systems are no longer optional.

But there have been many previous false dawns. Steven Van Kuiken of McKinsey, a consultancy, argues that the main obstacle to EMRs is the misalignment of costs and benefits among different groups. Although large hospitals, insurers and vendors would reap big gains from computerisation with quite small investments, he notes, small surgeries with just a few doctors face enormous headaches in converting from clipboards to keyboards. So they tend to be wary: a recent study by Accenture, another consultancy, estimated that barely 10% of American doctors use modern EMR systems.

In addition, many hospitals and insurers have not embraced open, interconnected EMR systems, choosing instead to keep patient data locked away from competitors' eyes in proprietary systems. Historically, IT spending has tended to focus on payment systems and other internal processes rather than better customer service or improved outcomes. But that may be changing as a result of pressure from government, employers and consumers.

The federal government is giving a push to EMRs, following the lead of the Veterans' Health Administration (VHA). Studies have shown that thanks in large part to its sophisticated national database, the VHA has fewer patient errors and better health outcomes than the health system at large, despite the fact that its patients tend to be older, poorer and sicker. George Bush wants a system of universal health-records by 2015. And Medicare, the government-run health scheme for pensioners, is shifting to a tiered reimbursement system in which it pays doctors more if they go electronic.

Employers are also keen on technology, since it promises to curb health-care costs and improve efficiency. Intel, BP, Wal-Mart and several other big companies got together last year to form Dossia, an independent, non-profit company that will develop an EMR system to give employees lifelong, portable medical histories. And over a hundred other firms including Dell, IBM and Microsoft now allow employees to manage their health affairs via WebMD, a big health-information website.

Wayne Gattinella, WebMD's boss, says the popularity of this corporate product persuaded his firm to

develop a version for individual consumers, supported by “discreet” targeted ads for pills, devices or relevant consumer products. “The consumer will be the catalyst to drive doctors and community hospitals to adopt IT,” he says.

Intuit, known for its accounting software, is convinced the market is ready for health-care software too. But when it tested such a product last year, it found that users were frustrated at having to fill in so many forms and search for bills and records to which they did not have easy access. So it now plans to offer its software in conjunction with health insurers, so that payment data and other information can be filled in automatically.

Aetna, a big insurance firm, has taken a different path by acquiring ActiveHealth, a firm that provides EMRs for around 14.5m users and also scours those health records with decision-support software to spot signs of trouble (such as missed doctors' appointments or early warnings of obesity). Aetna plans to offer this software to its own customers.

Others also hope to cash in on the expected health-care technology boom. Around 120 firms, from Panasonic and Cisco to Kaiser Permanente, have formed the Continua Health Alliance to promote open standards and interoperability among consumer-health products. Banks are licking their chops at the prospect of “health savings accounts”, and Intuit and WebMD are devising software to manage them. The prognosis for the wider adoption of technology in health-care is finally starting to look more promising.

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Retailing

Private lines

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Mid-range brands suffer as department stores focus on “private label” clothing

THIS month Liz Claiborne, an American clothing firm, reported a 65% drop in profits for the first quarter, largely due to a 7% fall in sales in its wholesale division. This includes clothing lines such as Dana Buchman and Ellen Tracy, which the firm sells to department stores. Take a stroll through JCPenney, one of America's biggest department stores, and you can see why sales have plunged. Private-label brands such as Worthington, Arizona and a.n.a., designed and made by JCPenney, now make up nearly 50% of its total sales. At Macy's, another big department store, private-label lines have been growing three times as fast as wholesale lines—making private-label clothes the fastest-growing product category in American department stores.

Macy's has devoted extra floor space to private labels such as American Rag and Alfani, and has even displayed them in the sorts of in-store boutiques normally reserved for designer brands. Last year JCPenney opened a temporary store in New York's Times Square devoted to its private-label brands. (The trend is not limited to America: private-label brands are on the rise in British department stores such as Selfridges and Harrods, which are expanding their own clothing lines.)

Department stores are also working with famous designers and celebrities to differentiate their offerings, increase their appeal and generate extra publicity. Last year Oscar de la Renta and Elie Tahari signed on to create clothing lines for Macy's, which already has a line of Donald Trump menswear (presumably woven from a strange, orange natural fibre). In the autumn Vera Wang, a designer best known for her wedding dresses, will unveil a line of women's clothing at Kohl's, a budget-conscious department store.

Design teams work directly with clothing manufacturers to create private-label lines, avoiding the mark-up applied by apparel companies which normally serve as middlemen between retailers and manufacturers. This means higher margins for the department stores. Robert Drbul of Lehman Brothers, an investment bank, estimates that private-label brands are 10-15% more profitable. But the risks are greater, too: if the clothes sell poorly, the retailers absorb all the losses.

Furthermore, private-label brands do not appeal to all buyers. Marshal Cohen of NPD Group, a market-research firm, notes that private labels are unpopular among the wealthy and the young, who account for about one-fifth of the market. This gives traditional brands an opening. Liz Claiborne plans to expand its high-end lines, such as Juicy Couture and Lucky Jeans, in department stores. As well as being more profitable than mid-range brands such as Ellen Tracy, their sales have been growing by 20-30%. The firm says it will continue to acquire luxury brands such as Kate Spade, which it bought last December, to focus on customers who find private-label brands unappealing.

For their part, department stores are under pressure from fashion chains such as H&M and Gap, which are using many of the same tactics. H&M launched its “M by Madonna” line in March, creating hysteria as customers queued for hours to buy the clothes. The company has now moved on to its next celebrity line—a limited collection of swimwear inspired (and modelled) by Kylie Minogue, a singer. Kate Moss, a supermodel, designed a line of clothes for Topshop, a British fashion chain, that is also being sold in Barneys, a New York department store. And Gap's high-end line, Banana Republic, has signed a five-year deal with Safilo Group, an Italian luxury-eyewear firm, to sell Banana Republic-branded frames and sunglasses in Safilo's Solstice stores, other retailers and possibly in department stores, too.

Mr Cohen predicts that department stores will respond by creating stand-alone shops for their private-label brands and selling their wares in other stores. There is, after all, only so much floor space in any given department store. If so, the future for private-label brands may well be outside their parent companies' doors.

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The end of Hanson

Live by the sword

May 17th 2007
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A buyout pioneer is itself bought

FEW endings could be more fitting than that of Hanson, Britain's most swashbuckling corporate raider. The firm that once struck fear into managers of companies on both sides of the Atlantic with its hostile bids agreed on May 15th to a debt-fuelled takeover by HeidelbergCement of Germany.

Had they still been alive, Hanson's founders James Hanson and Gordon White would not have been surprised by the sale. Unlike other conglomerators of their time, they were as comfortable selling businesses as they were buying them. Lord Hanson often said that if anyone wanted to buy his group he would send a taxi to fetch them.

It was not empty rhetoric. Soon after teaming up in the 1950s to establish a greeting-card company, Hanson and White sold it, using the proceeds to buy a sack-and-fertiliser firm. A string of acquisitions followed, taking them into businesses from cement to Jacuzzis.

The businesses may have been disparate, but the idea was revolutionary. A decade before the titans of American private equity formed Kohlberg Kravis Roberts, Hanson Trust was borrowing money and snapping up cheap firms. The firms they bought had to meet just two criteria: they had to be able to generate enough cash to pay the interest on the debt needed to buy them; and they had to cost less than the total value of their assets. Closures of head offices and mass sackings often followed.

Having spent three decades building the firm, Lord Hanson started to dismantle it in 1996. In some ways its time had come. Although it was a conglomerate like no other, investors began to value it at less than the sum of its parts. Lord White once said of takeovers that “you cannot fault others for picking up the jewels that sleep, or that unimaginative managements have been unable to recognise, even as they lie right beneath their noses.” Little wonder that when faced with a bid, Hanson went quietly.

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Siemens

Headless chicken

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The beleaguered German conglomerate seeks a spotless chief executive

THE leadership crisis has deepened at Siemens, Europe's biggest engineering group, just as the first convictions for bribery at the company have landed. Investigations into corruption reaching back at least seven years cost the jobs last month of Heinrich von Pierer, the chairman, and Klaus Kleinfeld, the chief executive (though they are not directly accused of wrongdoing). Gerhard Cromme, who took over as chairman, lost his best candidate for chief executive on May 14th, when Wolfgang Reitzle, boss of Linde, another German industrial group, categorically denied that he would take the job.

This week the company also suffered a blow in court when a judge in Darmstadt gave suspended sentences to two former managers for bribing employees of Enel, an Italian power company. The court fined Siemens €38m ($52m), part of the spoils it was reckoned to have gained from the Enel deal. Siemens and the two defendants are appealing against the decision. The firm argues that, before a law change in 2002, bribing employees abroad was not illegal unless they were government officials—an argument that will hardly win sympathy, even if it carries legal weight.

More court cases are expected to follow investigations by Munich prosecutors into bribery, which is now suspected to have amounted to as much as €1 billion over seven years to secure competitive contracts. Meanwhile, Nuremberg prosecutors are investigating allegations that improper inducements were paid to a union set up in opposition to IG Metall, Germany's most powerful blue-collar union.

The company's list of candidates for a new chief executive is short: the continuing investigation almost certainly precludes an inside appointment, with the possible exception of Mr Cromme himself as a stop-gap. Even that would be a mistake. Mr Cromme has headed Siemens' audit committee since 2005, and a scheme to bribe foreign officials appears to have thrived under its nose. *Der Spiegel*, a news magazine, says the committee took at least three months last year to respond to reports of dubious payments being made via Switzerland and Liechtenstein. Its instinct, it seems, was to hinder investigations until November 2006, when police raided Siemens's offices in Bavaria.

Now the sprawling conglomerate is overrun with auditors and advisers on compliance, but still lacks a firm hand at the helm. Mr Kleinfeld is a lame duck, having said he will go in September when his contract ends, or earlier if a successor is found. Mr Cromme and his supervisory board precipitated Mr Kleinfeld's resignation without lining up a successor. That is a cardinal error according to Germany's corporate-governance code, which was drawn up by a government committee chaired by, ahem, Mr Cromme. Both boards, the code says, must ensure there is “long-term succession planning”.

The ousting of Mr Kleinfeld last month always looked unwise. Now it turns out to have been even more ill-judged than it appeared at the time.

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Chinese trains

Bullet time

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The old China meets the new on the nation's new high-speed trains

ON THE first day of the peak May holiday week, China's railways carried 5.2m passengers. With a quarter of the world's rail transport loaded on to 6% of the world's track, the network is among the most heavily used on the planet. Last month China introduced its first 280 bullet trains as part of a scheme that will eventually raise passenger capacity by 18% and freight capacity by 12%, according to the railway ministry. Capable of up to 250kph (155mph), the new CRH (China Railway High-speed) trains have cut the journey time from Beijing to Shanghai by two hours to ten hours, and the trip from Shanghai to Suzhou to 39 minutes, just over half what it took before. Tickets were mostly sold out during the holiday week.

That was a triumph for the new trains, which have been dogged by criticism. Their introduction marked the sixth “speed-up” of China's railways and, as with everything else in the country these days, was given a “harmonious” label. Posters and press reports referred to “harmonious, made-in-China” trains and their use “in pursuit of harmony”—in short, to help address societal inequalities.

AFP

We wish we were on that train

For most of their first month in operation, however, they seem to have created discord instead. First they were attacked for not being very fast. Despite a $3.8 billion investment in track upgrades, there are only 6,000km (3,750 miles) of track where the new trains can reach an average speed of 200kph. The ministry says it will more than double the amount of high-speed track by 2020.

Ticket prices have risen by 50% on some routes and have more than doubled on others. This has caused resentment, and the ministry has admitted that it might introduce “substantial” price cuts on some routes. Ticket prices are still low by international standards, but migrant workers have been complaining in internet chat-rooms that the service provides “fast trains for the rich”. By law the ministry was supposed to consult with consumers over pricing and apply for approval from the State Council; it did neither. The ministry says the rules do not apply in this case.

Meanwhile, newspapers complain of a lack of manners on some trains. “Rough passengers” who litter, spit and “improperly use train services” have been reported in several provinces. Some travellers, perhaps believing that they need to get their money's worth, have resorted to stealing the taps from the carriage lavatories.

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Refining

A cracking trade

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Oil refineries are cashing in after years of lacklustre profits

THIS week average petrol (gasoline) prices in America reached a new record of $3.10 a gallon, according to the Department of Energy. Drivers are up in arms and politicians are getting twitchy. Congress is even considering legislation against price-gouging. The culprit is not the oil price, which has hovered above $60 a barrel for months, well below last year's record of $78. Instead the squeeze comes from a shortage of refining capacity. The difference between the price of the crude oil refineries buy, and that of the petrol they sell, has risen above $30 per barrel—a record for this time of year. Refining, long a marginal business, is becoming lucrative.

A number of catalysts are converting refineries into mints. The most immediate factor is an unusually high number of closures for maintenance. Most refineries schedule repairs for the springtime before the summer “driving season” begins. But this year eight times more capacity than usual has been shut down, according to official figures. That is partly because several refineries have still not recovered from accidents, including a deadly explosion at one of BP's American plants in 2005 and a fire at a facility belonging to Valero, another refining firm, earlier this year. Chastened by such disasters and the bad publicity they bring, managers are also taking more time and care over maintenance.

But even at the best of times America is short of refining capacity. No new refinery has been built in the country since the 1970s (though existing ones have expanded somewhat). Meanwhile demand for petrol has grown steadily and remains buoyant despite the high price. Francisco Blanch, an analyst at Merrill Lynch, calculates that a 50% increase in the wholesale price of petrol reduces demand by only 1%. As a result America imports an ever-growing proportion of its petrol, mainly from Europe. But imports are getting more expensive because of the weak dollar. Many refineries in Europe are also in the midst of repairs. Stocks of petrol recently fell almost as low as they did after hurricanes damaged several American refineries in 2005, though they have since picked up slightly.

Around the world there has been little investment in new refineries since the Asian economic crisis of the late 1990s, which saddled the region with huge overcapacity. European refiners also found themselves with too much petrol on their hands in the 1990s, thanks to an unforeseen shift towards cars that run on diesel. Such bountiful supply kept margins low.

But the overhang disappeared faster than expected because of rapid economic growth around the world, and in China in particular. At the same time, ever more exacting fuel specifications in Europe and America have made refineries there less productive. The Chinese government, for its part, caps petrol prices, forcing refineries to sell at a loss, so discouraging investment in new capacity in the world's fastest-growing market. The basic design of many older refineries has also contributed to higher petrol prices. These old refineries tend to churn out more fuel oil than petrol, but can often only sell the fuel oil at a loss. So a very high petrol price is needed to lure them into production.

Refining firms are now falling over themselves to announce new projects or expansions, especially for “upgraders”, which produce higher proportions of the most valuable fuels, including petrol. If all these plans were to be implemented, warns Lindsay Sword of Wood Mackenzie, a consultancy, there would be another glut. But she does not think they will be. Like every other part of the oil industry, refining is suffering from an acute shortage of building materials and skilled labour.

Tesoro, an American refiner, scrapped one scheme last year because of rising costs. Kuwait's national oil company has delayed another for the same reason. As recently as last year, American officials expected 1.6m barrels per day of new refining capacity to be built by 2011. Now they are projecting only two-thirds of that. Merrill Lynch does not see much new upgrading capacity becoming available until 2009 at the earliest. The next few summers will be expensive for America's drivers—and nerve-wracking for its politicians.

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Advertising

Spot the eyeball

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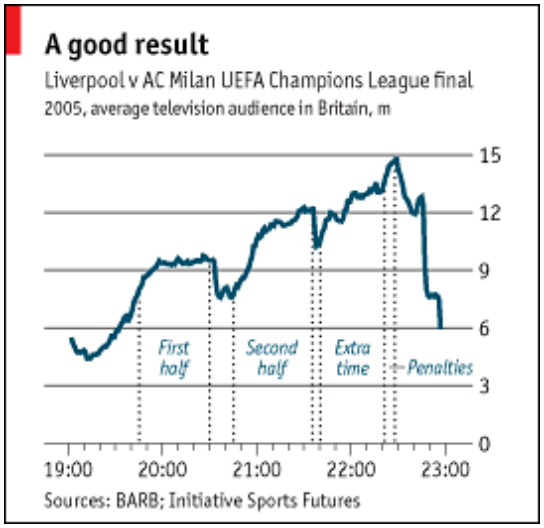
For advertisers, sports events need not be such a lottery

AS TELEVISION channels proliferate and audiences fragment, sports events have unparalleled pulling power. This year's main events are the American Superbowl, which averaged 93m viewers when it took place in February, and Europe's Champions League football final, which takes place in Athens on May 23rd. Last year's final attracted an average audience of 86m people; similar figures are expected this year, when AC Milan takes on Liverpool.

All those eyeballs should make advertisers cheery. But some will end up happier than others, because the audience grows and shrinks during the game. By looking at several years' data for English club-football games, researchers at London's Tanaka Business School and Initiative Sports Futures, a consultancy, found that the expected outcome of a game as the match unfolds influences the number of viewers. The less certain the outcome, the more people stay tuned. If the result seems a foregone conclusion, people switch off.



A good example was the 2005 Champions League final, also between AC Milan and Liverpool (see chart). With Liverpool losing heavily, many viewers switched off at halftime. Its unlikely second-half fightback, and eventual victory on penalties, was accompanied by a near-doubling in the number of viewers.

Broadcasters can capture some of this variation by charging advertisers on the basis of viewing figures. But ratings-based fees are retrospective and advertisers have to decide where to spend money ahead of time. Tanaka's Stefan Szymanski thinks there is an argument for “contingent” pricing, whereby advertising slots for sporting events would be pre-auctioned, with bids depending on the score at each point in the game.

Perimeter advertising—the electronic signs around the edges of the football pitch—would be particularly suited to this model. It is sold in time segments and is visible during the action, when viewers are most engaged. Kevin Alavy of Initiative Sports Futures reckons contingent pricing is still some years away, so his advice to clients is to buy perimeter advertising in the last few minutes of the game, when goals are most likely. Replays, highlights and press photos of goals can then ensure wide exposure for winning advertisers.

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Face value

The bulldozer

May 17th 2007
From The Economist print edition

AFP

René Obermann takes on the unions at Deutsche Telekom

BOOTING out bosses is something of a tradition at Deutsche Telekom. After running Europe's biggest telecoms group for seven years, Ron Sommer was ousted in July 2002 by the company's biggest shareholder, the German government. Kai-Uwe Ricke, his successor, lasted four years before getting the sack last November from the government and Blackstone, a private-equity firm that is now a big shareholder, after a series of bad results. And so René Obermann, who had been boss of the company's mobile-phone arm, moved into the hot seat.

Mr Obermann faces exactly the same problem as Mr Ricke did. The former state monopoly is not competitive because of its bloated, expensive workforce. A close confidant of his predecessor, he is going ahead with “Telekom 2010”, Mr Ricke's cost-cutting programme, against staunch opposition from workers' representatives who control ten of the 21 votes on Deutsche Telekom's supervisory board. He is also pushing forward with the planned transfer of some 50,000 staff into three service units under the name T-Service, where they will have a 38-hour work week rather than today's 34-hour week and will have their pay cut by 9%, in return for a guarantee that their jobs will be secure until 2011. Mr Obermann has spent much of the past two months in talks with unions to win their support for all this, but to no avail. On May 11th around 11,000 Deutsche Telekom workers went on strike to protest against the creation of the new service units, which is due to take place at the beginning of July.

Rather than adopting the usual conciliatory tone to pacify organised labour, Mr Obermann, who is variously known as “Dobermann” and “the bulldozer”, toughened his rhetoric over the weekend. The door to talks with unions remains open, he said, but if a solution cannot be found, the service units might have to be sold. He speculated that Deutsche Telekom might be broken up or taken over by a foreign buyer if his reforms failed. Either scenario would mean more job losses than under his proposals, he warned. He thinks his offer to the unions is generous and says he could simply have moved service jobs abroad to a low-wage economy, as other telecoms firms have done. Union leaders responded by persuading some 15,000 employees to down tools on May 14th and 15th.

Mr Obermann hopes to reduce Deutsche Telekom's annual costs by as much as €4.7 billion ($6.4 billion) by 2010. The establishment of T-Service will save an estimated €500m-900m a year. Bigger savings should come from a programme, started in 2005, which involves shedding some 32,000 of the company's 248,000 employees by 2008 through voluntary redundancies. But this will not be enough, say analysts, who reckon that another 10,000 jobs a year will have to go between 2009 and 2011 if Deutsche Telekom is to become competitive with its rivals. Labour costs amount to a quarter of Deutsche Telekom's sales compared with 18% of sales at France Télécom, 15% at Telefónica of Spain and 12% at KPN in the Netherlands. Arcor, the second-biggest fixed-line provider in Germany, which is controlled by Britain's

Vodafone, provides a comparable if not better service with a much smaller workforce.

Customers are voting with their feet. Last year some 2m of Deutsche Telekom's fixed-line subscribers in Germany defected to rivals. After a European Union directive obliged European telecoms companies to "unbundle the local loop"—jargon for granting rival firms access to the copper wires running into homes and offices—prices for fixed-line telephone calls fell in Germany by more than anywhere else in Europe. Smaller companies such as NetCologne, EWE and Versatel have attracted cost-conscious German customers with ever-cheaper flat rates for local calls. The mature domestic market, which accounts for about half of Deutsche Telekom's sales, remains the company's Achilles heel. Analysts say Mr Ricke should have expanded more rapidly into other countries, as rival firms did, in search of growth. Now Mr Obermann is under even greater pressure to expand abroad after Telefónica's recent investment in Telecom Italia, and he may try to buy France Télécom's mobile subsidiary in the Netherlands.

Bring it on

But Mr Obermann's handling of the strike will be the greatest test of his leadership. At 44, he is the youngest of the bosses of Germany's 30 largest companies and his rapid rise is evidence of his determination. After an apprenticeship as an industrial clerk he co-founded a mobile-phone company when aged only 23. Its sales reached several million euros within four years and the company was sold to Hutchison Whampoa, a Hong Kong conglomerate, in 1991. Mr Obermann could have retired then, but Mr Ricke spotted him and convinced Mr Sommer to hire him to run Deutsche Telekom's domestic mobile arm. Mr Obermann is seen as a role model by a new generation of young, dynamic German managers. But he is now staking his reputation, as well as his job, on his reform programme.

The German government, which retains a 32% stake in Deutsche Telekom, is not helping, at least not in public. The finance minister is keen to see the company prosper, but does not want to appear to support large-scale job cuts. Even so, Mr Obermann is in a relatively strong position. No high-profile business figure wants his job because of the government's meddling and the cantankerous unions. And the unions are not as powerful as they would like to be. Some 40,000 of the 80,000 staff in Deutsche Telekom's fixed-line business are civil servants. This means they are unsackable, but it also means they cannot go on strike. Overmanning means that the firm will probably be able to function almost normally in spite of the dispute, says Frank Rothauge, an analyst at Oppenheim, a German bank. Indeed, a prolonged strike could be just the proof Mr Obermann needs of the urgent need to slim down the leviathan's workforce.

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China and US trade

Lost in translation

May 17th 2007 | BEIJING AND HONG KONG
From The Economist print edition

Stephen Jeffrey

If China sharply revalued the yuan, as American politicians are demanding, it could actually hurt the United States and help China

Get article background

CHINA is being cast as the villain once again. By holding its exchange rate artificially low, it is stealing jobs and causing the United States to run a huge trade deficit. Beijing must therefore be forced to revalue the yuan. These are the arguments behind an increasingly protectionist mood in Washington. Yet they are largely flawed. A stronger Chinese currency would not much reduce America's trade deficit. Indeed, the irony is that China, not America, has more to gain from setting the yuan free. Without a more flexible exchange rate, there is a growing risk that China's sizzling economy will boil over.

America's anger at China is clearly growing. In February it filed a complaint to the World Trade Organisation (WTO) against Chinese export subsidies. In late March the Department of Commerce announced tariffs of 10-20% on glossy paper imported from China, to offset the impact of alleged government subsidies. This reversed a 23-year-old policy of not imposing countervailing duties on a non-market economy. Then in early April the Bush administration filed two more complaints: one on Chinese pirating of DVDs and CDs, and the other over restrictions on the sale of foreign films and music in China.

Although by themselves these actions are trivial, together they point to an increasing appetite for tougher action against China. The Bush administration is under increasing pressure, particularly from Congress.

Congressmen complain that the so-called China-US Strategic Economic Dialogue (a series of high-level talks between the two countries launched last year by Hank Paulson, the treasury secretary) has so far failed to produce results. The recent deterioration in trade relations does not bode well for the next meeting, which begins on May 22nd. Many commentators now reckon that Congress will inevitably pass some kind of China-bashing legislation later this year. A sharp economic slowdown in America as a result of the collapsing housing market would make this even more likely.

The biggest risk comes from measures linked to China's supposed exchange-rate misalignment. The infamous Schumer-Graham bill, which proposed a 27.5% tariff on all Chinese goods to offset the yuan's alleged undervaluation, was withdrawn last year. But the two senators behind it are working with others on a new WTO-compatible version that could soon appear. Although the new bill is unlikely to include across-the-board tariffs, it could have sharp teeth.

Meanwhile, the target of all this hostility looms ever larger: China's trade surplus with America increased to $233 billion last year, accounting for almost 30% of America's total deficit. China's total current-

account surplus reached an estimated $250 billion, or 9% of GDP, up from only 1% in 2001. Worse still, in the first four months of 2007, its trade surplus jumped by 88% compared with the same period in 2006.

The making of myths

China officially abandoned its decade-long policy of pegging the yuan to the dollar in July 2005. Since then it has risen by only 8% against the greenback. Because the dollar itself has weakened, the yuan's trade-weighted exchange rate has barely budged. In real trade-weighted terms it is about 10% cheaper than at the dollar's peak in 2002. As a result, it is not just the usual protectionist suspects that demand action, but many mainstream American economists are now calling on China to revalue by 20% or more. Yet the standard arguments for a revaluation are based partly on a series of myths.

The first myth is that there is overwhelming evidence that the yuan is grossly undervalued. China's large bilateral trade surplus with America proves nothing. It largely reflects Asia's changing supply chain. Much of what America buys from China today once came from Japan, South Korea and Taiwan. China now imports components from these countries, assembles them and exports the finished goods to America. Knock out these and America's bilateral deficit with China shrinks by more than half. Even so, China's overall current-account surplus is also huge. The surge in its foreign-exchange reserves, to over $1.2 trillion, also suggests that the yuan is undervalued: without those massive purchases of dollars, the currency would have risen.

However, not all economists agree that the yuan needs to be sharply revalued. At one extreme is Morris Goldstein, of the Peterson Institute for International Economics, who argues that the yuan is undervalued by 40% or more against the dollar and should immediately be revalued by 10-15%. In the other corner many highly respected economists, including Robert Mundell, an economics Nobel prize-winner, and Ronald McKinnon, of Stanford University, strongly argue against a big appreciation of the yuan.

The devil to measure

Economists find it devilishly hard to define the “correct value” for a currency. On purchasing-power parity (PPP), the yuan is clearly undervalued against the dollar. Perhaps by as much as 50%. But PPP is not useful for determining the optimal exchange rate between two countries of such different levels of income. It is natural for average prices to be lower in poorer countries because wages are lower. As countries get richer and their productivity rises, their real exchange rates appreciate. And although the depreciation in the yuan's real trade-weighted value since 2002 looks perverse, this follows a real appreciation of 50% between 1994 and 2001 (see chart 1).

A study by two IMF economists, Steven Dunaway and Xiangming Li, found that estimates for the undervaluation of the yuan ranged from zero to nearly 50%, depending on which method was used. Another recent study, by Yin-Wong Cheung, Menzie Chinn and Eiji Fujii, concluded that using conventional statistical methods it is hard to prove that the yuan is much undervalued. Such uncertainty may partly explain why America's Treasury Department has so far ducked labelling China as a currency manipulator in its twice-yearly report to Congress. Another reason is that it is loth to give ammunition to the protectionist lobby.

Myth number two is that the sharp increase in China's trade surplus is due to an explosion in cheap exports. Until 2004 China's surplus was relatively modest, but it soared over the next two years (see chart 2). Jonathan Anderson, chief Asia economist at UBS, points out that export growth actually slowed between 2004 and 2006 (see chart 3). The main reason for the bigger trade surplus was a sharp slowdown in the annual real growth rate in imports, from more than 30% in early 2004 to less than 15% last year.

The entire increase in China's trade surplus since 2004 has come from trade in heavy industrial materials and equipment. China used to import increasing amounts of steel, aluminium, chemicals and machinery, but import growth collapsed after 2004 when the government started to tighten policy, causing a sharp slowdown in construction, one of the biggest importers of machinery and materials. At the same time

China continued to invest heavily in metals and equipment, creating substantial excess capacity, so import growth remained relatively weak last year. Mr Anderson argues that imports should recover as overcapacity is used up.

The third fallacy is that imports from China destroy jobs and harm the American economy. It is hard to see how China can be blamed for job losses when America's unemployment rate (4.5%) is close to its lowest for decades. Trade with China may affect the composition of jobs in America, but it has little impact on total employment. It is true that some workers are harmed by trade with China, just as there are some losers from all international trade. But the American economy overall is better off, so in theory there is ample room to compensate any losers.

Trade with China helps, not harms the average American. Thanks to imports from China, prices are lower and real incomes higher. Commentators often refer to the “cheap” yuan as being an unfair subsidy for Chinese exporters. But it is a moot question who exactly is subsidising whom. Not only do cheap imports subsidise American consumers, but China's large purchases of Treasury bonds also hold down American interest rates, thereby subsidising home buyers. Suppose that overnight the yuan rose by 30%, what would happen? American interest rates would rise as China needed to buy fewer Treasury securities and prices at Wal-Mart would increase. If consumer spending and imports then collapsed, this would certainly reduce America's trade deficit, but in a much more painful way than most Americans have in mind.

Wishful thinking

The biggest myth of all is that a revaluation of the yuan would greatly reduce America's trade deficit. The real cause of the deficit is that Americans spend too much and save too little. This means that the country has to import surplus savings from abroad by running a current-account deficit. If a stronger yuan did not cause Americans to save more, it would do little by itself to reduce the trade deficit.

Another reason why even a big rise in the yuan would do little to reduce America's deficit is that there is little overlap between American and Chinese production, so American goods cannot replace Chinese imports. Instead, other countries, such as Indonesia and Vietnam, would probably replace the Chinese. Shifting purchases to higher-cost producers amounts to imposing a tax on American consumers, says Stephen Roach, chief economist of Morgan Stanley.

Even where America and China do compete, as in electronics, the high import content of China's exports blunts the impact of exchange-rate movements on export prices, because a rise in the yuan reduces input costs. About half of China's exports consist of goods that have been assembled from imported components. And domestic wages and materials account for about 30% of the cost of those re-exports. Mr Anderson estimates that a 10% rise in the yuan would increase average export prices by only 3-5%.

If a yuan revaluation encouraged other Asian economies to follow suit, the impact on America's trade deficit would be larger, but still modest. If a 10% revaluation of the yuan were matched by all other Asian currencies, the dollar's trade-weighted index would fall by 4%. Yet, the 19% decline in the dollar's trade-weighted index since early 2002 has failed to trim the deficit.

None of this means that a yuan revaluation leaves America's trade deficit unchanged, simply that any change would probably be small. Nouriel Roubini, of Roubini Global Economics, finds evidence that China's trade balance is affected by movements in its exchange rate: the yuan has fallen sharply against the euro since 2002 as a result of the dollar's decline, and China's exports to Europe have consequently grown at a faster rate than its exports to America. A stronger yuan might therefore curb China's exports to America, but America's deficit would continue to loom large if imports from China were simply replaced by those from elsewhere.

Chinese whispers

Many of the arguments heard in America in favour of a big revaluation of the yuan are flawed or at least exaggerated. However, many of the arguments used in Beijing for why a revaluation would endanger China's economy are equally suspect. For instance, the common claim that a big jump would seriously harm China's growth and employment contradicts the argument (also favoured by Beijing) that an appreciation would have little effect on China's trade surplus with America.

Or take another popular line of defence: it is often asserted that China cannot afford a more flexible

exchange rate until its dodgy banking system is reformed and strengthened. Eswar Prasad, an economist at Cornell University, says this argument has it completely backwards. The distortions caused by today's rigid exchange-rate regime may themselves be the biggest threat to Chinese financial stability. A sound banking system requires an independent monetary policy, which uses interest rates rather than blunt directives, to guide credit. And a country cannot control its monetary policy unless it accepts a more flexible exchange rate.

By tying the yuan closely to the dollar, China has been forced to hold its interest rates lower than is prudent: higher rates would attract more “hot money” from abroad, putting upward pressure on the currency. The real rate of interest paid on bank deposits is negative and lending rates are far too low for such a fast-growing economy. Cheap money results in excessive bank lending and poor investment decisions, which could lead to an increase in non-performing loans. Excessively low interest rates are also fuelling stockmarket and property bubbles.

News that China's real GDP surged by a breathtaking 11.1% in the year to the first quarter and that consumer-price inflation had risen to 3.3% in March (it eased to 3% in April), stoked fears that the economy is out of control. But concerns about overheating in the usual sense of excess demand are exaggerated. China's widening current-account surplus and its strong investment imply excess supply. Excluding food, the inflation rate is only 0.9%. Instead, the real concern is that excess liquidity, as a result of the surge in foreign-exchange reserves and low interest rates, is flooding into shares (see article). Households are withdrawing money from low-yielding bank accounts to bet on the stockmarket. China needs much higher interest rates to cool its asset markets. To regain control over its monetary policy China needs to let the yuan rise.

A revaluation could also help the government succeed in shifting the balance of growth away from investment and net exports towards consumption. A stronger exchange rate would boost consumers' purchasing power, allowing them to buy more foreign goods. Excess saving in China is as much to blame for global imbalances as inadequate saving in America.

Most of the increase in saving has come from Chinese companies, which are earning record profits. But household saving is also kept high by the poor public provision of health, education and pensions. Partly as a result, consumption accounts for an unusually low share of GDP.

The good news is that the mix of growth is starting to become more balanced: over the past year, investment has slowed while retail sales have quickened, rising by 15.5% in the year to April. In other words, consumer spending is now growing faster than GDP. Dragonomics, a Beijing-based research firm, estimates that consumption rose from 37% to 40% of China's nominal GDP growth in 2006 and is set to rise again this year.

The stronger growth in Chinese consumer spending has got much less attention in America than the sharp increase in the country's trade surplus. The contribution of net exports to China's growth has increased so far this year. However, the near doubling of its trade surplus in the first four months of the year was probably a one-off, because firms brought forward their shipments so as to avoid an expected reduction in export-tax rebates. Exporters are also thought to be overstating their export revenues in order to dodge capital controls and bring in foreign money to invest in Chinese assets. If so, the trade surplus should stabilise in coming months.

In the long run, stronger domestic consumption could trim China's trade surplus. The government can encourage this by spending more. Its spending on health care and education rose by an average of 50% last year and it is budgeted to rise by more than 60% this year—but from such low levels that it could take years to increase social spending by enough to encourage households to save a lot less. Meanwhile, a stronger yuan would help to rebalance the mix of China's growth.

Mirror image

This turns the whole debate about China's exchange-rate policy on its head. It is China that has the most to gain from allowing the yuan to rise. If the spat between America and China were to ignite protectionism or financial instability, it could endanger the whole world economy. All the more foolish, therefore, that economic relations are based on misperceptions on both sides. America needs to stop making China a scapegoat for the failures of American policy. Only if it gets its own economic house in order, by boosting domestic saving, will its “advice” to Beijing seem credible. Likewise, China has no right to criticise American policy when its own economy remains unbalanced.

America is right that China needs to revalue, but for the wrong reasons. And arguing that a revaluation helps America's economy makes it less likely that Beijing will act. Moreover, if George Bush foolishly slapped harsh trade sanctions on China, America's economy would be the biggest loser. Likewise, China is foolish to resist a more flexible exchange rate partly because it does not want to be seen as caving in to America's demands, when it is in its own interest. If the world's two leading engines of growth remain at loggerheads, everyone will pay the price.

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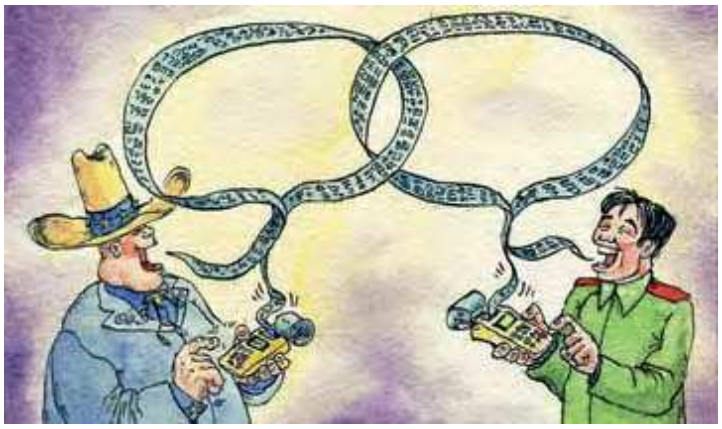
International accounting

Speaking in tongues

May 17th 2007 | NEW YORK
From The Economist print edition

David Simonds



Dragging America down the rocky road to a set of global accounting rules

FORGET Esperanto. Too straightforward. The *lingua franca* that is increasingly spanning the globe is a tongue-twisting accounting-speak that is forcing even Americans to rethink some precious notions of financial sovereignty.

International Financial Reporting Standards (IFRS), which aim to harmonise financial reporting in a world of cross-border trade and investment, have made great strides since they were adopted by 7,000 or so listed companies in the European Union in 2005. To date, over 100 countries, from Canada to China, have adopted the rules, or said that they plan to adopt them. The London-based International Accounting Standards Board (IASB) expects that to swell to 150 in the next four years.

Even America, no ardent internationalist, is working with the IASB to narrow the gap between its own accounting standards and IFRS, which foreign companies listed in America could choose by 2009, or possibly sooner. Today such companies must “reconcile” their accounts with American rules—a costly exercise that some believe is driving foreign listings away from the United States.

In late April America's Securities and Exchange Commission (SEC) unexpectedly floated the idea of giving American, and not just foreign, companies the choice of using IFRS. Critics of the idea claim that this will give companies the option of shopping around for whichever regime best suits their business. Inevitably, however, by opening the door (if only a crack), America's own accounting regime would be in jeopardy.

But even the EU's embrace of IFRS has been less than effusive. It chose a version of the rules endorsed by the European Parliament, rather than one issued by the IASB. There is only one difference, but it is a big one—the rule on how to account for financial instruments (derivatives and the like). European banks believed the rule, which would require companies to value financial instruments at their market value (which fluctuates) rather than at their historic cost (which is often zero), would have caused too much volatility in financial accounts. Politicians and some central bankers agreed. After a protracted and unresolved tussle with the IASB, the European Parliament unilaterally carved several paragraphs out.

One carve-out is bad enough for the IASB—but it seems to have set a worrisome precedent. A fight has recently erupted over “IFRS 8”, which lets company bosses choose how to divide up their business segments for reporting purposes, much as American standards allow. Investors, especially in Britain, are furious, claiming the rule gives managers too much discretion and that it represents the wholesale adoption of “alien” (read American) ways. In April the European Parliament forced the European Commission, which had been set to ratify the standard, to delay its vote pending further study. The British Accounting Standards Board has stepped in as peacemaker, proposing adoption of the rule with a review in a year and a half.

Kuwait and other countries in the Middle East, too, are said to be adopting IFRS with certain peculiarities. The worry is that if enough countries seek to tailor standards to their liking, there could be “hundreds of different versions of IFRS instead of one set of international rules, which is the whole point,” says Sir David Tweedie, the head of the IASB. “We have to nip this in the bud.”

So far, nipping means working with international standard setters to compel companies to disclose exactly what set of rules they are using. The hope is that investors would press companies not to use country-specific, bespoke versions of IFRS, or charge them higher risk premiums if they do. Today, an investor in Europe could not tell from reading a company's financial report whether it is using full-blown IFRS or the EU version.

Whether pure IFRS or not, all countries are prone to interpret the rules in ways that reflect their old national accounting standards, according to KPMG, an accountancy firm. Regulators are working through IOSCO, an international body of securities regulators, to attempt to whittle down these differences.

The task is further complicated by the fact that international accounting rules tend to be “principles based”, which means there are no hard-and-fast codes to follow. This is different from America, where accounting principles are accompanied by thousands of pages of prescriptive regulatory guidance and interpretations from auditors and accounting groups, some of it gleaned from SEC speeches. IFRS have no such baggage, leaving more room for judgment.

This in turn means that it is perfectly feasible that two companies can view a similar transaction very differently—as long as each can support its judgments. Consider the international accounting rule that governs consolidation, which defines when a company should include its investments in its accounts. Donald Gannon, a partner at Deloitte, an accountancy firm, calls it “one of the best examples of a truly principles-based standard”. Unlike America's complicated and highly prescriptive rule—which Enron, an energy giant, and others managed to skip around to keep debt-laden entities off their books—the international standard requires firms to use their judgment in deciding whether they control an entity. That includes considering their economic stake (eg, share of dividends or profits), corporate governance (eg, voting rights) and other powers (eg, the ability to set financial policy).

Two companies might weigh these same factors and come up with different answers. But this, claims David Schmid of PricewaterhouseCoopers, another accountancy firm, is not a problem: “Transparency is the greater goal in accounting, not comparability.” In his view, as long as accounting standards flush out information that faithfully reflects the reality of the underlying business, an investor can do his own sums and either accept or reject management's judgments. The other option—piling on rules that aim to cover all contingencies—might make comparisons easier. But imposing such rules around the world would be so hard that it would consign IFRS to join Esperanto on the dust-heap of dashed dreams.

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Corporate finance

The new railway barons

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The leverage express rides the rails in America. Hold on tight

WITHIN ten years of the “golden spike” ceremony at Promontory Summit, Utah in 1869, the celebration of the completion of the first coast-to-coast railway, borrowings came due and a debt crisis shattered the exuberance. On May 15th, and in a new age of optimism, Warren Buffett and Carl Icahn detailed large separate stakes in railway companies. Neither investment mogul has given much explanation as to why he sees further scope for an industry in which share prices have more than tripled in the past four years. But they are investing alongside some activist hedge funds which are planning to load the railways up with debt.

It has been a long time since railways have been so fashionable. Rail's share of inter-city freight traffic declined from 75% in 1929 to 38% in 1980, thanks to new roads and increased competition from trucking. In 1976 the Department of Transportation indicated that the owners of one-third of the Class I railways (11 of 36) were losing money on their investment. Deregulation in 1980 led to more than 20 years of restructuring and consolidation. Only seven Class I railways survived.

AP

Just like old times

Now the profits are pouring in. Strong demand for coal, agricultural and container services—the “holy trinity” of freight—has trains running at full steam. Heavy volume, price increases and cost reductions have led to growth, and rail capacity is stretched. This week, in a lawsuit that evokes memories of 19th-century trust-busting, the biggest railways are accused of price-fixing fuel surcharges. Buffs are calling the boom the “rail renaissance”.

Mr Buffett's investment company, Berkshire Hathaway, bought shares in three railways last month: Union Pacific, Norfolk Southern, and Burlington Northern Santa Fe. Mr Buffett, a famous bargain hunter, has made this investment just as managers were issuing warnings to investors about slower price and volume growth. Analysts had also been playing down share-price prospects until the two barons came on the scene.

But they are not the only ones climbing aboard. The Children's Investment Fund (TCI), a London-based hedge fund better known for agitating for change at ABN AMRO, a Dutch bank, and Deutsche Börse, the German stock exchange, has recently poured over $1 billion into American railway companies, including those held by Berkshire Hathaway and Mr Icahn. According to Snehal Amin, a TCI partner, the rationale is simple: railways could use more gearing. Most carry debt on the balance sheet of about two times earnings before interest, tax, depreciation and amortisation. He thinks they could bear more than five times.

This comes when big railways are already using their spare cashflow to raise dividends and buy back shares. Last week CSX, an operator whose shares are held by Mr Icahn and TCI, announced a $1 billion buy-back and a 25% rise in its quarterly dividend. TCI may well encourage it to use debt to finance more such manoeuvres in the future.

If railway executives fail to gear up, private-equity firms may well do it for them. Although most railways are quite large—CSX has a stockmarket value of $20 billion—almost no deal is out of reach for buy-out firms. And if they come sniffing, share prices will rise even more.

Judged against the long boom-and-bust history of the railways, it is not clear how long the good times will last. Demand for freight shipped to and from China may extend the cycle. That would need to happen for

a great deal of extra debt to make sense in such a volatile industry.

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China's stockmarkets

Feeding frenzy

May 17th 2007 | SHANGHAI
From The Economist print edition

Share prices are exploding in Shanghai

Get article background

IN THE West when share prices go up, you are told to “fill yer boots”. In China the advice might be “fill yer face”. A new measure that Chinese retail investors use to justify entry into the booming stockmarket is that share prices in nominal terms are still cheap—at least compared with the price of a plate of pork.

But what's odd about that? Even standard measurements, such as price to earnings, have a surreal feel to them. Many companies trading on the Shenzhen and Shanghai bourses are at ratios last seen during the internet bubble of the late 1990s, or, closer to home, the Japanese and Taiwanese bubbles of two decades ago. Bank of Communications, China's sixth-largest bank, began trading on May 15th with a 71% leap on its first day. Its shares are now priced at 42 times expected earnings, a staggering level even given China's heady growth rate. One of its attractions is a stake held by HSBC, a global bank. HSBC trades at a meagre 13 times earnings.

High valuations do not deter punters. Five million new Chinese brokers' accounts were opened in April, two-thirds more than during the whole of last year. Retail demand, a result of individuals facing the simple choice of low-yielding bank accounts or booming stockmarkets, has helped push the market up by half this year and 250% in the past two years. Even housekeepers are reported to be leaving low-paid jobs to play the market.

Companies, too, are piling in. Earnings of Chinese-listed firms are being jet-propelled by “investment income”, observes William Liu, head of China research at CLSA Securities. That makes market movements blissfully self-reinforcing—higher share prices mean higher earnings—although of course it could work just as strongly in reverse, too.

China's government knows that a crash might well bring social upheaval, so it is gingerly trying to impose order. On May 11th a handful of politically connected institutions were granted permission to invest domestic funds outside the mainland, principally in Hong Kong.

Of far more weight would be for the authorities to open the country's capital account, and to allow short selling, which would wipe out the share-price discrepancy between China and Hong Kong. The government could also give retail investors more access to commercial paper, or high-quality bonds, so that they have an alternative to low-yielding bank accounts. However, it will permit only a trickle of each, because it fears cutting into the fat margins that banks earn from paying depositors next to nothing and lending at high rates—a margin that is needed to cover for the banks' bad loans.

Perhaps the most important change would be to allow investors more access to information on company performance. Western investment banks could play a role here; unlike their American counterparts, they restrict the amount of information they convey to the public. As it is, retail investors have little to go on except price movements; and if you are not sure what the earnings are, no wonder you compare prices with the cost of your last meal.

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Buttonwood

Mean or meaningless?

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From The Economist print edition

Averages need to be treated with caution

CONSIDER these two statements: the American stockmarket was overvalued in 2000; company profits are high relative to economic output. Many people would agree with both propositions, but implicit in each is that there is a correct, or normal, value for shares or profits. The corollary is that when share price or profits are too high or too low, they will eventually revert to the mean. But what do people mean by mean?

Efficient-market theory, which states that prices already reflect all available information, presents an immediate problem for the idea of a reversion to the mean. If share prices were obviously too high, investors would sell their holdings until prices fell to the correct level. There would be no extremes to revert from.

However, in the light of the dotcom bubble, it seems inherently unsatisfying to argue that markets are always fairly valued. Such a position also gives a green light to those who argue that “it's different this time”, and who use any old valuation measure (price per eyeball for internet stocks) to justify share prices.

Pinning down the right mean, however, is difficult. American profits look high by the standards of the past 20 to 30 years. But they do not look unreasonable relative to 1950s and 1960s levels. Perhaps the 1970s and 1980s (which saw high inflation and double-digit interest rates) were the aberration and the immediate post-war era was the norm.

Things get even more complicated when investors start to talk about stockmarket valuations. Most analysts tend to use the prospective price-earnings ratio as their chosen measure, rather than the historic figure. They justify this by saying that investors look forward, not back. But banks are in the business of selling shares. Since analysts nearly always forecast rising profits, the prospective p/e ratio is usually lower than the historic one; that makes the market sound cheaper.

But it also creates a problem when making historic comparisons. It is hard to get figures for earnings forecasts before the 1980s. So when analysts say the market looks cheap on a historic basis, they are really saying it looks attractive relative to a period that saw one of the greatest bull markets ever known.

You can avoid this by using a cyclically adjusted p/e ratio, which averages profits over the past ten years. On that basis, Wall Street looks pretty expensive, but the ratio assumes that profits are set to mean revert.

Switching to dividend yields or asset prices as a valuation measure does not eliminate the problem. The average dividend yield on the American market between 1926 and 1950 was 5.5%, according to Barclays Capital. With Wall Street currently yielding less than 2%, that makes shares look very expensive. But bulls argue that conditions in the first half of the 20th century, which suffered two world wars and a depression, and had a stockmarket dominated by individual investors, are irrelevant to today's markets.

To critics such as Andrew Smithers, of the consultants Smithers & Co, such an argument counts as “data mining”, the exclusion of statistics that do not support the bulls' case. He says the stockmarket does revert to the mean, in that periods of high returns tend to be followed by periods of low returns. On his preferred measure, the q ratio (the relationship of share prices to the replacement cost of net assets), stocks are now clearly overvalued.

However, the Smithers thesis presents investors with two obvious problems. The first is that shares have looked overvalued, on his measure, since the mid-1990s. Full reversion has not yet occurred; this has not been a very useful trading signal. The second is that there have been relatively few peaks for q. Have there been enough cycles to make a convincing case?

A subtle variant of the mean reversion case is put forward by Jeremy Grantham of the fund management group GMO. He says that share valuations do revert to trend, but the trend is rising over time (thanks to better economic stability and lower transaction costs). While this may sound plausible, it is a slippery concept to use in practice. If valuations rise, how do you know whether the market is overvalued or that the trend rate has accelerated?

Investors need to distinguish between short- and long-term means. The first may bolster the case of bullish analysts, but depend on “it's different this time” arguments. Longer-term ratios are more intellectually robust, but investors can go broke waiting for them to revert. Sometimes, means can be very mean.

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German Landesbanks

Fischer's chips

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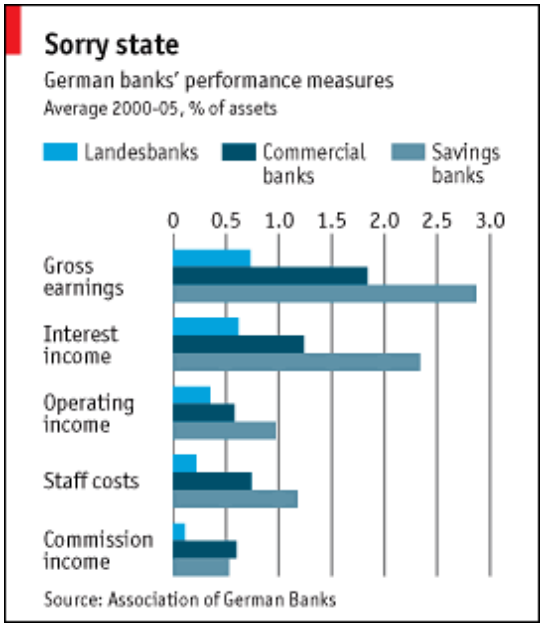
From The Economist print edition

A casualty on the road to consolidation among Germany's state-owned banks

Infographics



IT WAS hardly a surprise when WestLB, Germany's third-biggest Landesbank, pulled out of the bidding this month for Landesbank Berlin Holding, a publicly owned banking group that must be sold by the end of the year. Thomas Fischer, who heads WestLB, has issues closer to home—but he will be regretting the loss of a golden opportunity to get bigger.

Still in the running for Landesbank Berlin are Commerzbank, the only private bidder; LBBW, the south-west German Landesbank; Bayerische Landesbank; and DSGV, the savings-banks association. Binding bids must be in by June 1st. An alternative for the city-state of Berlin is to do a secondary offering of its 81% stake. That would disappoint the hedge funds that have been driving up the price of the 9% of shares already quoted.

The prize is the 1.9m customer-base of the Berliner Sparkasse, which Landesbank Berlin owns. But its sale, which was demanded by Brussels in 2004 after a public bail-out, is another step in the urgently needed consolidation of the unwieldy Landesbank sector.

There is little justification for more than a couple of Landesbanks, which act as wholesale banks for the savings banks, let alone the nine groups that exist. Apart from LBBW, which can provide banking services to retail customers, they have performed poorly during the past five years (see chart). Only two have taken the step of letting in private capital: Landesbank Berlin, and HSH Nordbank, which sold a 10% stake to JC Flowers, an American private-equity firm. The Land of North-Rhine Westphalia recently resolved to sell its 17.5% stake in WestLB. So the sale of a Landesbank that can contribute almost 2m customers in Berlin, as well as a reasonably successful capital-markets team, could spur further consolidation.

This makes it particularly galling for WestLB to be mired in a trading scandal that prevents it from playing an active role. Last month Mr Fischer sacked his head of global markets and a top share trader after a deal went wrong, leaving a negative position of roughly €100m on the books. WestLB officials say the two men, Friedhelm Breuers and Markus Bolder, broke trading limits. Mr Breuers, through his lawyer, says the trades were approved by the managing board and no limits were breached. He is suing the bank for unfair dismissal.

A loss of €100m dents WestLB's reputation more than its balance sheet. There were hopes the bank had come through the days of ill-conceived gambles, such as the €1.2 billion ($1.5 billion) hole found in its British private-equity unit in 2003. It is the least profitable of the three biggest Landesbanks, with an embarrassing cost-income ratio of 92%. Without the support of its government owners, it has an individual credit rating from Fitch of D, the weakest of its peers.

Responsibility for the trades, which involved big short positions in Volkswagen's and BMW's ordinary shares, and big long positions in their preference shares, will hinge on whether they were kept in the trading book or the so-called banking book, where WestLB makes strategic investments. Market sources say the managing board would most probably have been aware of banking-book positions unless compliance controls had failed. Last week WestLB confirmed it had suspended two of its compliance staff.

The fiasco is embarrassing for Mr Fischer, chief executive since 2004, who once headed risk management at Deutsche Bank. It weakens his position with the regional politicians and savings-bank chiefs who control WestLB via its supervisory board. It may hasten a tie-up with local savings banks, or with another

Landesbank. It has missed this round of consolidation; it could conceivably find itself on the receiving end of the next one.

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Italian banks

Marriage of convenience?

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It may not be UniCredit's first choice, but Capitalia would be a neat fit

JUST when UniCredit, one of the top two Italian banks, was supposedly courting France's Société Générale, a tasty morsel pops up right under its nose in the form of Capitalia, Italy's third-largest bank.

SocGen would surely be the more desirable catch, especially with European banking a-twitter over the battle for ABN AMRO, the Dutch bank. But Capitalia would be far easier to bed down, which is why insiders believe that in a matter of days, UniCredit might well make a friendly move on its Italian neighbour.

It would be a takeover, not a merger. UniCredit is far bigger in size, with a market value of €79 billion ($107 billion), compared with Capitalia's €21 billion. UniCredit's name would remain, and there would be plenty of costs to crunch by imposing its systems on Capitalia. Capitalia is almost starved of options. The merger of Banca Intesa and Sanpaolo IMI, which forged one of Italy's top two banks, killed its ambitions of being anything but a target in the consolidation of Italy's banks.

Meanwhile, UniCredit, having focused on growth abroad, suddenly found its 10% share of the Italian market lagging behind Intesa Sanpaolo's 17%. With Capitalia, UniCredit would acquire a further 6%. That might well be its last chance of getting back on even terms with its challenger at the top of the Italian banking league—even if it does not quite give UniCredit the satisfaction of claiming the biggest market share.

Italian politicians would be likely to bless the merger, as they did that of Intesa and Sanpaolo. So would the Bank of Italy, which is keen to see Capitalia's future neatly settled with a domestic buyer, as well as the creation of a second very large Italian bank, perhaps too big to fall prey to outsiders.

Could anything go wrong? Spain's Santander has long had designs on Italy, and might secretly covet ABN AMRO's stake in Capitalia. France's BNP Paribas has previously had designs on SocGen, though it says it is less interested now. UniCredit's shareholders might be sorry that the bank is not giving greater priority to its international expansion plans than its domestic ones.

For UniCredit's boss, Alessandro Profumo, there might be something a little disappointing about walking down the aisle with a local conquest, rather than a tantalising French beauty. On the other hand, if he absorbs Capitalia swiftly enough, maybe SocGen will still be waiting for him.

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Economics focus

Use IT or lose it

May 17th 2007
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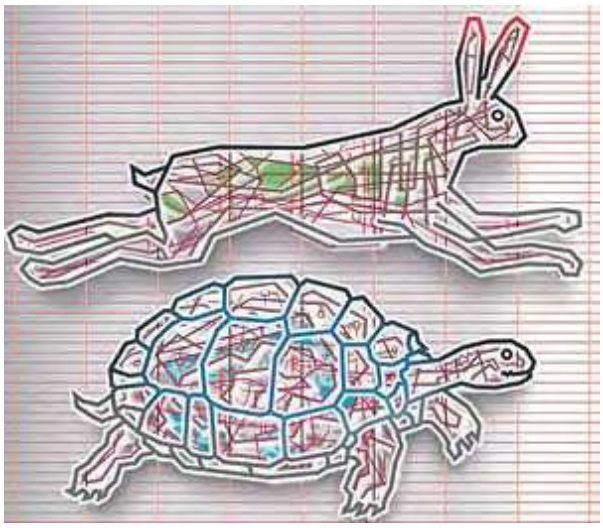
Jac



New calculations shed more light on Europe's productivity malaise

LATELY, pleasant surprises about European economies have been popping up with happy regularity. Unemployment in the euro zone ticks down again; output grows a bit faster than forecasters had hoped; a survey finds that German businessmen are even more cheerful than they were the last time they were asked. Much more of this and—who knows—people may even stop being startled by it.

That the world can still be surprised says something about Europe's knack for lowering expectations of its economic performance, especially next to America's. It is now generally accepted that in around 1995, after 20 sluggish years, American productivity growth began a remarkable surge that only now seems to be subsiding. Yet the advances in information technology (IT) and the dramatic cheapening of computing power that lay behind that surge have had much less effect on Europe's productivity. In 2006, admittedly, Europe's output per hour grew faster than America's. But the cheer over that number merely points up the disappointment over the many years that came before.

The recent appearance of a new database, the fruit of a project called EU-KLEMS, that accounts for the sources of European growth and productivity does not alter this broad impression. However, the figures and an accompanying report* edited by Bart van Ark and Gerard Ypma, of the University of Groningen, and Mary O'Mahony, of the University of Birmingham, give the fullest picture yet of where Europe has been missing out.

Between 1970 and 1995 output per hour in America grew at an average rate of 1.3% a year. Then the pace picked up markedly, to 2.4% in 1995-2004. While America accelerated, Europe stalled: having managed 2.4% a year in 1970-95, the European Union's oldest 15 members reached only 1.3% in 1995-2004. In the second period two northern countries, Finland and Sweden, were the best of the Euro-bunch. Two southerners, Italy and Spain, were the worst. The Spanish could at least say that their economy grew quickly and claim that low productivity growth reflected a remarkable increase in employment. The Italians are without even that comfort.

The EU-KLEMS team chop up Europe's productivity performance along two dimensions. First they split the total into the contributions of different industries. Then they divide output growth, in individual sectors and in the market economy, into the contribution of various inputs: hours worked, the mix of skills in the labour force, IT capital, other capital and “multifactor productivity” (MFP)—in theory, the adroitness with which the other inputs are combined; in practice, what is left over after changes in labour and capital are stripped away.

Growing pains

At the industry level, Europe enjoyed rapid productivity growth in the electrical machinery and communications industries, which among other things produce IT. Output per hour there rose by 7.2% a year in 1995-2004, against 5% in the previous quarter-century. But America's acceleration was even more impressive, from 7.5% to 10.4%—a pace that among the Europeans only the Finns and Swedes could beat. More important was Europe's poor showing in services. Productivity growth fell in distribution (from 2.4% in 1970-95 to 1.7% in 1995-2004) and in finance and business services (from 1% to 0.3%). In America the annual growth rates of output per hour leapt from 2.6% to 4.4% in distribution and from 0.2% to 2.6% in finance and business services. Together, the two sectors yielded more than half of America's productivity growth in 1995-2004.

One inference is that Europe was not only worse than America at making IT, but also much worse at using it. That is borne out by the EU-KLEMS economists' attribution of output growth to the various inputs. In this exercise, because of the limitations of the data, they used figures for only ten countries and compared 1995-2004 with the previous 15 years rather than 25. Most European countries used more IT, relative to other forms of capital, after 1995. But America underwent a much bigger shift into new technologies.

Even more dismal was Europe's rate of MFP growth—the biggest element, says the study, in the productivity slowdown. Between 1980 and 1995, the ten countries' market economies grew by 1.9% a year on average. MFP chipped in 0.7 percentage points. In 1995-2004, overall growth was faster, 2.2% a year—but MFP contributed less, 0.3 points. In finance and business services, where gross value added went up by 3.5% a year, MFP subtracted 1.3 points. In Italy and Spain, average MFP growth in the market economy was negative.

Most economists will be grateful for the study's detail. And most of them will no doubt still be puzzled by Europe's tardiness in exploiting IT, given the ease with which ideas now travel. Another new study† may make them more puzzled still. Nick Bloom, of Stanford University, and Rafaella Sadun and John Van Reenen, of the London School of Economics, find that British factories of American multinationals are more productive than the country's other foreign-owned establishments, which in turn are sharper than locally owned rivals. The Americans not only use much more IT per worker, but they also exploit it more effectively: even for a given amount of IT capital, their productivity is higher. That suggests British firms, at least, have not only fallen behind American practice but have not even caught up with methods that Americans have imported to Britain. Still, last year's figures may be a sign that Europe is cottoning on. Europeans should hope so.

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* “The EU-KLEMS Productivity Report”, issue 1, March 2007. Available online at www.euklems.net/index.html

† “Americans Do I.T. Better: US Multinationals and the Productivity Miracle”, CEP Discussion Paper no. 788, April 2007: cep.lse.ac.uk/pubs/download/dp0788.pdf

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Biodiversity

Fathoming out evolution

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A survey of the Weddell Sea uncovers extraordinary biological diversity

THREE hundred years after the birth of Linnaeus, the Swedish naturalist who established the concept of a biological species, no one has much of a clue how many species there are on Earth. Taxonomists—bipedal apes who tend to inhabit temperate zones in the northern hemisphere—have characterised what is under their noses reasonably well. A fair amount is known about the life in tropical forests, too. And a back-of-the-envelope calculation based on the 1.8m sorts of organism recognised so far as species under the Linnaean system, on the rate at which new species are being discovered and on such ecological matters as the average number of parasites (themselves new species) that each free-living species harbours, suggests the final total may be around 30m.

But that 1.8m starting point is mainly from the land and the upper reaches of the sea. What is going on in the deep ocean is so badly understood that estimates of biodiversity there range from 100,000 species to 100m. The reason for this is that sampling the ocean depths is tricky and expensive—and doubly so in the seas around Antarctica. That is why the results of three German expeditions by the vessel *Polarstern* to the Weddell Sea, published in the current issue of *Nature*, are a big step forward. Angelika Brandt, of the Zoological Museum in Hamburg, and her colleagues have found an extraordinarily long list of new species in the frozen depths.

Dr Brandt's team discovered this novelty by sampling deeper than the 500 to 1,000 metres frequented by their scientific predecessors. They also used nets capable of capturing the smallest animals. They picked up critters from as deep as 6km, and they did so using both typical trawling nets and a special box that was designed to scoop up a slab of ocean floor along with a slice of undisturbed water from immediately above it. Many patient taxonomists from several European countries and America then sieved through litres of muddy gravel with microscopes and pairs of tweezers to see what treasures had been captured. Each litre was found to contain up to 40,000 animals, many of them species new to science.

The isopod pictured above, for example, is but one of some 600 new species of these woodlouse-like creepy crawlies. That triples the number of Antarctic isopods known. More to the point, though, is that as *Polarstern* pursued its mission during the summers of 2002 and 2005, the rate at which new isopod species were discovered did not decline. That suggests biology has only scratched the surface of isopod diversity—and in the grand scheme of things, isopods are a pretty obscure group. This implies that the total biodiversity of the Weddell Sea is enormous.

The questions are, where did that diversity come from? And does the answer point to a more general

mechanism for generating diversity? Dr Brandt thinks she knows the answer to the first question and that it bears on the second.

Pump up the volume

At the moment, many biologists suspect terrestrial biodiversity is something that is generated in the tropics and exported to the rest of the world. Why the tropics are so diverse is something of a mystery, but one explanation is called a species pump. This hypothesises that climate change associated with ice ages regularly shrinks and fragments the forest into isolated “refugia”, which go their own merry evolutionary way. When the climate improves and the forest expands, all the new species that have evolved in the refugia mix. Then the process happens all over again.

A similar thing could happen in the Weddell Sea. Growing ice shelves would make the shallows uninhabitable. The ocean depths would act as the refugia. Then, when the ice melted, the shallows would act as a mixing bowl for the newly evolved species.

Dr Brandt and her colleagues built family trees of their new species to see whether a species pump of this type might explain their findings. It did. Many of the novel isopods, for instance, could be grouped as closely related pairs of species, with one of the pair found in shallower waters and the other down in the depths. That is exactly the pattern that would be expected if deep-dwelling creatures had spread into the shallows and evolved into shallow-dwellers. The tropical rainforests and the Weddell Sea may, as it were, be polar opposites as habitats. But it looks as though their species richness is caused by the same underlying mechanism.

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The environment

Not on the label

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Why adding "carbon footprint" labels to foods and other products is tricky

WOULD you like a footprint on your food? Labels already show fat, salt and sugar content, among other things. But now several British food companies and retailers plan to add "carbon footprint" labels showing the quantity (in grams) of carbon-dioxide emissions associated with making and transporting foods and other goods. The first such labels appeared on packets of Walkers crisps in April. Boots, a British pharmacy chain, will add carbon labels to some of its own-brand shampoos in July. These labels were produced in conjunction with the Carbon Trust, an environmental consultancy funded by the British government, as part of a trial scheme. Tesco, Britain's biggest retailer, has also announced plans to apply carbon labels across its product range and many other firms plan to do the same.

If the idea can be made to work, carbon labels will allow shoppers to choose the products with the smallest carbon footprints and make it possible for them to compare locally produced and imported foods, as well as conventionally farmed and organic products. Claims that some kinds of food are more energy-efficient than others and worries about "food miles" would give way to "a much more rounded, inclusive picture," says Euan Murray of the Carbon Trust.

But calculating the carbon footprint of a product is far from easy. Unlike the fat or sugar content, it cannot be measured directly. For a start, how far back up the supply chain do you go? Academic "life-cycle analyses" go into painstaking detail, factoring in the emissions associated with building factories in which food is produced, for example. But doing this for thousands of products would be a mammoth undertaking. The trick, says Mr Murray, is to find the right trade-off between rigour and a methodology that works across thousands of items. The Carbon Trust's approach is to include carbon dioxide produced in the manufacturing but not, say, that from employees commuting to work.

How far down the supply chain do you go? The Carbon Trust's labels aim to show the carbon emissions associated with making something, packaging it, getting it to the store and disposing of it. Because bags of crisps delivered to far-flung shops will have travelled farther from the factory, the auditors use an average figure for transport emissions. Similarly, national averages feed into calculations of whether a product or its packaging are recycled, incinerated or put into landfill.

The labels do not count the energy needed for refrigeration, lighting and heating in shops. Nor do they include the emissions that come from using a product. The carbon footprint of boiled potatoes, for example, is dominated by the emissions associated with cooking them. Whether you put a lid on the pan can make more of a difference than how they were farmed, or whether they were produced locally or not. Similarly, the emissions of shampoo depend on how long you spend in the shower, how hot the water is and the quality of your boiler. Such things cannot be captured in a carbon label, so they are not included, says Mr Murray.

A particularly difficult area is agricultural modelling. Some sources of farm emissions, such as the electricity consumption of a milking shed, can be measured directly. Others, such as nitrous-oxide emissions from soils and methane emissions from animals, cannot. For the latter, mathematical models are used instead, says Adrian Williams, an agri-environmental scientist at Cranfield University in England. Such models contain assumptions that not everyone may agree with, however. A recent report funded by DEFRA, Britain's environment agency, found that some organic foods had larger carbon footprints than conventional ones. It was criticised by the Soil Association, Britain's main organic lobby, which took issue with the models used for the calculations.

To complicate matters further, nitrous-oxide and methane emissions from farms far outweigh carbon-dioxide emissions in global-warming potential. Methane and nitrous oxide are taken into account by converting them into "carbon-dioxide equivalent" emissions using conversion factors provided by the Intergovernmental Panel on Climate Change. But the quantification of nitrous-oxide emissions is still not well understood, says Dr Williams, so it is not clear which model to use.

Getting agreement on how best to calculate carbon footprints depends on debate between scientists, retailers, farmers, lobbyists and others. The Carbon Trust has begun a year-long consultation and this month a meeting took place at the Environmental Change Institute at Oxford University, which is looking into carbon labelling for Tesco. Agreement is vital because the labels will be useful only if there is a common standard. Otherwise consumers will not be able to compare apples with apples, as it were.

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Astrophysics

The prints of darkness

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A ghostly ripple of dark matter is "seen"

EITHER Newton and Einstein were wrong, or there is something missing from the universe. The reason for this is that galaxies do not behave as the laws of gravity predict they should. Most galaxies rotate at a speed that should cause them to fly apart if all that holds their visible matter together is gravity, as physicists understand it. So either that understanding is flawed, or there is more to the average galaxy than meets the eye.

Most physicists tend to the latter opinion. They think the universe is stuffed with invisible matter composed of particles different from the ones that make up visible matter and the gravity of this "dark" matter holds galaxies together. Their equations all make sense if that is true. The problem is that invisible, dark matter is, well, invisible. But data from the *Hubble* space telescope, about to be published in the *Astrophysical Journal*, may have overcome its obscurity.

A couple of years ago James Jee of Johns Hopkins University in Baltimore and his colleagues trained *Hubble* on a cluster of galaxies 5 billion light years from Earth and used a technique called gravitational lensing to work out how mass is distributed within this cluster. A gravitational lens is formed when light is bent by a massive object. Einstein predicted the distortion of light in this way in 1915, as part of his general theory of relativity. Three years later a British physicist, Arthur Eddington, decided to test this idea by watching what happened to light from stars that were close in the sky to the sun during a solar eclipse. Sure enough, their light was bent by the mass of the sun, confirming Einstein's theory.

By looking at how a cluster distorts the faint light coming from galaxies behind it, Dr Jee and his team created a map of the distribution of its mass. They then compared that with what they could actually see. Instead of finding that the mass coincided with the location of the ordinary, visible matter of stars, as had been seen in observations of other clusters, they found a distortion.

After trying and failing for months to explain this distortion away, Dr Jee accepted it was real and sought to account for it. The most plausible explanation is that the cluster contains a distinct ring of dark matter without any accompanying ordinary matter.

To try to find out where this ring had come from, the team trawled through previous literature on the cluster. They found an earlier suggestion of a truly enormous collision between the cluster and one of its neighbours between 1 billion and 2 billion years ago. This work, published in 2002 by Oliver Czoske of Bonn University in Germany, was based on an analysis of the distribution of visible matter in the neighbourhood.

Dr Jee and his colleagues think the ring is evidence of this collision. When the impact happened, the dark matter in the clusters also collided. It then rebounded, rather as a ripple spreads after a stone has been thrown into a pond. And that rippling ring may be proof that Newton and Einstein were right after all.

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Evolution and politics

Security check

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Why conservatives had happy childhoods but liberals have more sex

RANDY THORNHILL is not a man to shy away from controversy. It was he who showed, just over a decade ago, that like most other animals who pick their mates by sight, the thing that humans seem to value above all in a partner is bodily symmetry. It was also he who argued that far from being a pathology, a propensity to rape is a normal part of the evolutionary inheritance of men—a point of view previously confined to militant feminism. Now he is looking at the evolutionary roots of political preference. In particular, he is asking if there is a Darwinian explanation for why some people are liberals and some conservatives. Curiously, his answer also casts light on the ideas of another 19th-century scientist, Sigmund Freud.

Psychologists have long known that conservatives and liberals differ in more than whether they vote Tory or Labour, Republican or Democrat. Indeed, the perverse mixtures of policies on offer from these parties, conflating social conservatism with economic liberalism and vice versa, mean that voting preferences are often an unreliable guide. But bundles of personality traits do tend to cluster together in people. Some are sceptical of tradition, open to new experiences, rebellious, pleasure-seeking, egalitarian and risk-prone. Others value tradition, duty, close family relationships and security.

Alamy

Mummy's boy, or not

What no one knows is what causes the difference—and, inevitably, some people prefer genetic explanations while others cleave to environmental ones. Dr Thornhill and his colleague, Corey Fincher, however, come down on neither of these sides. They think an individual's early environment is responsible for switching on one pattern or the other, but that this switch is an evolved—and thus genetically controlled—response.

The crucial environmental factor, they believe, is childhood stress—particularly how securely someone was attached to his mother when a child. And they lay out their case that this is so in a paper just published in *Evolution and Human Behavior*.

To conduct their study, the two researchers asked 123 students from the University of New Mexico, where they both work, to fill in a questionnaire. This asked about the volunteers' political beliefs, personality traits and childhood memories. Dr Thornhill and Dr Fincher then used a version of what is known as the Wilson-Patterson conservatism scale to classify their volunteers as conservatives or liberals on the basis of their personality traits. (Conservatives complain, with some justification in this case, that academics have a tendency to pathologise conservatism by defining liberalism as a default from which conservative tendencies deviate, in the same way that a schizophrenia scale or a depressiveness scale measures a deviation from healthy normality.)

When they correlated their volunteers' Wilson-Patterson scores with childhood memories the researchers discovered that those classified as conservatives tended to report having had secure childhoods with strong attachments to one or both parents, and low stress. Those classified as liberals reported having stressful childhoods and weaker attachments to their parents. Freud, on this reading, was right about the importance of early experience on character formation.

The second part of the paper is more speculative. Conservatives, the authors suggest, are likely to do best in stable societies—say, a village where there is plenty to eat and no marauding enemy, and the biggest danger to stability might come from dissatisfaction within the community. The traits associated with liberalism, on the other hand, might be most effective when there is a lot of stress on a population. If food

is scarce and other people are pressing in, then a liberal's willingness to challenge traditional ways of doing things, and his greater willingness to embrace outsiders (often literally; liberals tend to have more sexual encounters than conservatives) might come in handy. Evolution has thus fixed it so that appropriate patterns of personality are activated in response to the environment in which they are most likely to cause an individual to thrive.

Which is all fine and dandy—except that last year a group of researchers at the University of California, Berkeley, came to exactly the opposite conclusion. Their study found that insecure and fearful children were more likely to grow up into conservatives, and that confident kids were more likely to become liberal. Clearly, as scientists are so fond of saying, more research is needed.

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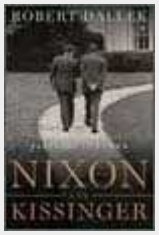
Richard Nixon and Henry Kissinger

The poison, if not the fruitfulness

May 17th 2007
From The Economist print edition

Meanness and mistrust marked relations between the two men who dominated American foreign policy in the early 1970s

Nixon and Kissinger: Partners in Power
By Robert Dallek



HarperCollins; 740 pages; $32.50.
To be published in Britain by Allen Lane in August

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Amazon.com
Amazon.co.uk

Corbis

NO ONE, remarked Bismarck, has any idea how much charlatanism there is in diplomacy. He was not, but might have been, referring to that odd couple, Richard Nixon and his national security adviser and then secretary of state, Henry Kissinger. Robert Dallek, the author of several books on American presidents, culls 2,800 hours of the Nixon White House tapes and 20,000 pages of transcripts of Mr Kissinger's telephone calls to add to previous accounts. The result is a mesmerising close-up of an unusually poisonous yet fruitful relationship.

The president's distrust of Mr Kissinger did much to destroy his administration. Nixon's downfall was in the end brought about by the “smoking gun” contained in his own White House tapes. The taping mechanism had been installed to provide an accurate account of his conversations with his national security adviser in order to prevent Mr Kissinger from falsely claiming credit for Nixon's accomplishments.

Each man questioned the other's sanity. Nixon told a top aide to keep a file on Mr Kissinger's mental health. For his part, Mr Kissinger, obsequious in the presence of Nixon, in conversations with journalists would refer to Nixon as a “madman”, “maniac” or “meatball mind”. The insults went further. Nixon called Mr Kissinger his “Jew boy” behind his back and, occasionally, to his face. Mr Kissinger would remain silent or even support Nixon's anti-Semitic outbursts. For both men, secrecy and deceit were the *modus operandi*.

Among those whose telephones were tapped were close aides of the secretaries of state and of defence; this was tantamount to recording the conversations of their bosses. The secretary of defence used the National Security Agency and the army's signal corps, which was in charge of secure White House telephone calls, to keep tabs on both Mr Kissinger and Nixon. A naval yeoman attached to the National Security Council was instructed to go through secret files of Mr Kissinger's that had been put aside in “burn bags” for destruction and make copies for the joint chiefs of staff. Alexander Haig, Mr Kissinger's deputy, would surreptitiously supply the president with transcripts of Mr Kissinger's telephone conversations. No wonder Mr Kissinger believed his line was tapped. And no wonder both president and national security adviser were routinely described by their colleagues as “paranoid”.

In Mr Dallek's view, each was willing to see lives sacrificed for domestic political advantage. In late 1970 Mr Kissinger believed that America could get out of Vietnam any time it wanted and that it would do so before the 1972 election. The president wanted to plan the removal of all American troops by the end of 1971. Mr Kissinger counselled against that idea because, if America's South Vietnamese allies were then destabilised, it might hurt Nixon's re-election campaign. He recommended a pull-out in the autumn of 1972, “so that if any bad results follow they will be too late to affect the election”. Nothing was said about how many Americans, or Vietnamese, would die in the interim.

Among Mr Kissinger's unguarded comments are his reference to the North Vietnamese as Russia's “little yellow friends” and his advice to Hafez Assad, the brutal president of Syria, that their mutual goal should be to avoid a situation that helped “the Jewish newspapers in the United States”. Daniel Ellsberg, who leaked the “Pentagon Papers” (secret Defence Department analyses and documents concerning America and Vietnam), was characterised by Mr Kissinger as the “most dangerous man in America today”, who “had to be stopped at all costs”.

Mr Dallek does not offer a comprehensive evaluation of the Nixon-Kissinger foreign policy. No mention is made of such decisions as the ending of the Bretton Woods monetary system. Other gaps are even more astounding. When Leonid Brezhnev, the Soviet leader of the day, suggested joint action against China's nuclear facilities, the proposal is recorded—but not Mr Kissinger's response.

Moreover, Mr Dallek's interest in new material seems to come at the cost of mastering existing sources. This leads to some misleading accounts. Mr Dallek's strength, though, is in reporting the personal relations that so entangled the web.

Nixon and Kissinger: Partners in Power.
By Robert Dallek.
HarperCollins; 740 pages; $32.50.
To be published in Britain by Allen Lane in August

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Stalin

The makings of a monster

May 17th 2007
From The Economist print edition

IT TAKES a lively ambition to write yet another biography of Stalin, and Simon Sebag Montefiore, having written one already, does not quite have that. This book is restricted to the early years of the man who became the architect of the Great Terror in the late 1930s. Many of the big questions about Stalin and his regime are therefore set aside, but there is plenty to make up for this absence.

Young Stalin
By Simon Sebag Montefiore

To be published in America by Knopf in October
Weidenfeld & Nicolson; 432 pages; £25.

Buy it at
Amazon.com
Amazon.co.uk

Mr Montefiore has a thesis. For him—and he is surely correct in this—the Gulag and the mass deaths in 1937-38 were a pivotal point in the history of the 20th century. His intuition is that the politics of Stalin did not appear on the stage unheralded. To prove his point, he has delved into the boyhood and early manhood of the Great Terrorist, hoping to show that he was dangerously unhinged and deeply misanthropic throughout his life.

The author cannot be faulted for industry. With help from Russians and Georgians, he has dug up a pile of fresh information. Stalin did not say much about his life before the October 1917 revolution. Occasionally, he told stories to his dinner guests, and usually he lied or dissembled in the telling. With good reason. At school he was notorious for his nasty little tricks in fights with his friends. At the Orthodox seminary where he trained to become a priest, he was often fighting again, usually unprovoked. In his Marxist faction he annoyed everyone with his endless intrigues. In prison he organised the killing of another inmate. In Siberian exile he seduced an under-age girl and had to promise the police he would marry her when she came of age (he did not, of course).

Stalin was especially averse to publicising one of his greatest escapades, even though it had been carried out on behalf of the communists. In 1907 he organised an armed robbery on two coaches carrying treasure to the state bank in central Tbilisi. It was one of the most audacious thefts in Europe at the time, widely reported in newspapers around the world, and Stalin proudly delivered his ill-gotten gains to Lenin. But Marxists in general disapproved of such robberies, as they brought their cause into disrepute. Stalin lay low.

Mr Montefiore argues persuasively that Stalin was already identifiable as a monstrous personality before the fall of the Romanov monarchy. At the same time he seeks to prove the entire communist movement guilty by association. He comes close to saying it was no accident—one of Uncle Joe's favourite phrases—that Stalin should assume supreme power after Lenin's death in 1924.

The account would have been the better for more nuances. It seems harsh to imply that most communists were psychological misfits long before they seized power. On the other hand, it is undeniable that several communist leaders in the Soviet Union and elsewhere feasted on their chances to butcher their enemies. Mao Zedong, Pol Pot and Mengistu Haile Mariam trod a path marked out by Lenin and Stalin.

This is an attractive book, despite the themes of dictatorship and terror. Mr Montefiore recognises that even so terrible a man as Stalin had a side to his personality that was not to his discredit. He appreciated literature. He liked to crack jokes, albeit at someone else's expense. He was a good singer. And he had a laudable wish to improve himself educationally. What a complex monster.

Young Stalin.
By Simon Sebag Montefiore.
Weidenfeld & Nicolson; 432 pages; £25.
To be published in America by Knopf in October

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The Falklands war

Sharp battles, blunt words

May 17th 2007
From The Economist print edition

FEW wars are without their oddities. The small war in the Falklands 25 years ago had plenty. One, which this belated book of eye-witness accounts illuminates, concerns the origins of the invasion. Having murdered about 10,000 of their citizens, and tortured many more, Argentina's military rulers embarked on an almost kid-glove “liberation” of “their” Islas Malvinas.

The Argentine officials sent to administer the islands no doubt had reason, after the event, to emphasise their goodwill towards the islanders. Yet none of the Falklanders quoted here makes any serious complaint about his treatment. And the one real Argentine thug, the new police chief, was swiftly sacked.

On Britain's side, much was similarly out of kilter with the stereotypes. Its foreign and defence ministries displayed a bumbling incompetence that actively encouraged the Argentine folly. As for the prime minister, Margaret Thatcher, her fault was not her famed toughness but complacent inactivity. At no point before the invasion were the Argentines warned that if they were to poke Britain in the eye they would get a bloody nose. The toughness came later.

This book will equally disillusion those who believe that Britain's battlefield response was a smooth display of combined operations. Far from it. Some of it was a shambles. Inter-service, and intra-service, discord plainly abounded. Few of those chosen for citation have a good word to say for the decisions of Admiral Sandy Woodward, the commander of a task group, who was stationed, justifiably, far offshore in his aircraft-carrier, *Hermes*. Perhaps because he has had his say already in an autobiography, he is not among the people quoted here.

The long-running controversy over the Argentine cruiser *General Belgrano*, torpedoed as it sailed away from the British exclusion zone, gets its come-uppance in seven words from a British admiral: the cruiser “could have turned around at any time”. A smaller row, about the shooting-down of an Argentine supply plane, is similarly dismissed by the British pilot concerned in a few curt words: “Well, bloody hard luck, mate...That's the way war is.”

Those interested in the tactical intricacies of a minor war will value this book. If it seems flat on the personal details of what it felt like to the participants, that may be partly because it is short of Argentine contributions. For that, go to “Los Chicos de la Guerra”, published in 1982.

Forgotten Voices of the Falklands: The Real Story of the Falklands War in the Words of Those Who Were There.
By Hugh McManners.
Ebury Press; 496 pages; £19.99

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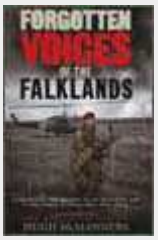

Ebury Press; 496 pages; £19.99

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Empires

No questions, no lies

May 17th 2007
From The Economist print edition

“ALL our pomp of yesterday/Is one with Nineveh and Tyre!” sang Rudyard Kipling, foretelling the end of the empire he loved. That much he could predict, but he could not foresee that, within the century after he wrote “Recessional”, every scrap of the European empires that bestrode the world of 1900 would be gone.

Kipling assumed that the United States would acquire an empire, but it did not—not, at least, an empire of the kind he was used to. The vestiges of Spain's worldwide dominions were up for grabs, and the arc of territory from California to Texas had already been absorbed and settled by English-speaking Americans. Yet Cuba and the Philippines, captured after the Spanish-American war of 1898, were soon let go in favour of a new notion that John Darwin calls “informal empire”, and Cubans denounce as neo-imperialism.

Mr Darwin's thesis is that imperial visions linger on well after the captains and kings have departed. He is mainly interested in what he calls Eurasia, and knows most about the British end of that vast landmass. Portugal, Spain, France and the Netherlands get little of his attention.

His idea of an empire is not rigorous. The first one he considers, that of Tamerlane, the Mongol warlord Timur Leng, spread from the Mediterranean almost to the Bay of Bengal, but promptly collapsed on its founder's death. Russia's empire spread less rapidly, from the Baltic to the Pacific, but most of its western parts dropped off just as fast when the Soviet Union imploded.

China's rulers brought much of its eastern periphery into what was once recognisably an empire but is now pretty clearly a nation-state. Britain's Indian raj came about when a set of coastal trading-posts expanded to take over the institutions of the preceding Mughal regime. The last, greediest stage of imperial expansion, in Africa and the Pacific, was motivated less by an appetite for territory than by the wish to keep others out of it.

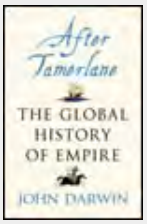
The author's virtue is that, unlike many fashionable historians, he does not try to dress up past events as rehearsals for coming ones. His deficiency is a reluctance to look for explanations. Were Timur's Mongol horsemen driven by a sudden growth of population on their home steppe? By a change in its climate? By dynastic rivalries with other Turkic clans? He does not speculate. If empires need administrators from the imperial power, how did Portugal, whose ruling class was already overextended by the mid-1500s, hold on to so many of its dominions into the 1970s? The tricky questions are not even asked.

If the book's 500 dense pages contain a message, it is lost amid the sheer accumulation of events, conquests and collapses. Mr Darwin's reading is immense, but his prose is diffuse. Sometimes hindsight gives his story a theme, as when the fragmentation of Ottoman authority after 1920 created a bundle of unstable Arab states in a region whose oil resources did not at the time seem all that important.

Forecasts, though, are not on offer. The author sees the present advance of globalisation as the product of “a set of recent agreements, some tacit, some formal, between the four great economic ‘empires’ of...America, Europe, Japan and China”. But can they reconcile their cohesion with the “disturbing effects of free competition”? Time will tell, but not this book.

After Tamerlane: The Global History ofEmpire.
By John Darwin.
Allen Lane; 575 pages; £25.
To be published in America by Bloomsbury in January 2008

After Tamerlane: The Global History of Empire
By John Darwin



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Japanese fiction

Sleepless in Tokyo

May 17th 2007
From The Economist print edition

WIDELY considered one of Japan's best authors, Haruki Murakami writes fiction that combines both realism and surreal fantasy. His stylish and economical 13th work takes place over seven hours of a Tokyo night, when casual acquaintances and complete strangers meet, all burdened by alienation, loneliness and suppressed desires.

At the heart of the book are two sisters. Eri, a fashion model, does nothing but languish in a death-like sleep in a menacing netherworld, her black hair cascading across the pillow “like a flood of dark water”. Her younger sister Mari, a student, prefers to be awake, and spends the witching hours drinking coffee and reading in an all-night restaurant before her encounters with a strange, yet comforting, group of night people: Takahashi, an introspective jazz trombonist; Kaoru, the brusque manager of a love hotel; Guo Dongli, a young Chinese prostitute brutalised by a suited *sarariman*, who is somehow linked to the slumbering Eri.

Mr Murakami's narrative flows slowly, and his portrayal of the dead hours of a city creates a rounded sense of place. Here is a Tokyo with its neon lights out, its digital screens silenced, with cats scratching at rubbish bags, couples twined in doorways and a late autumn moon hanging in the sky “like a sharp blade”.

The author describes adeptly the empathy and understanding that can occur between strangers bound by fate, and his account of the growing intimacy between Takahashi and Mari is moving. But for all its enigmatic qualities the book leaves an empty feeling, with the unexplained mystery of the sleeping Eri a particular source of frustration. Even with its flaws, though, “After Dark” is a reminder that, however close the involvement of two people, they can never know each other completely.

After Dark.
By Haruki Murakami. Translated by Jay Rubin.
Knopf; 191 pages; $22.
Harvill Secker; £14.99

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By Haruki Murakami.
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Memoirs

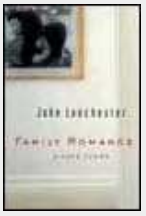
Serial nun

May 17th 2007
From The Economist print edition

THE notion of a young Irish girl entering a convent as a postulant in the impoverished County Mayo of the 1930s is hardly surprising. But, after a year inside, Julia Gunnigan had the guts to leave: she could not stand the discipline and she missed the world. A joyous re-entry to home and friends, though, was not to be. She was shunned by her family, and the death of her fiancé from tuberculosis propelled her back into the convent.

This time it was for 15 years, and the tale told by John Lanchester of her life as a Presentation Sister in the years before the reforms of the Second Vatican Council is the most revealing part of his book. Mr Lanchester wonders how she could have contemplated, let alone endured, the rigours of such a life a second time. She knew by then that it would be her duty as a nun to die as an ego, as a self. She knew, too, that she would be encouraged to flagellate and otherwise "discipline" herself. And she knew that she would have to wear heavy medieval clothes and that her underwear, like her body, would be washed only once a week.

Family Romance: A Love Story
By John Lanchester



Putnam; 384 pages; $27.95.
Faber and Faber; £16.99

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As Sister Eucharia, she moved to Madras (now Chennai) in India for missionary work. In an autobiographical short story for the BBC broadcast in 1961, titled "My Hair and Me", she talked of the five pieces of clothing, including starched bands of stiffened rubber material, that she wore in the stifling heat. Her hair was shorn to a quarter of an inch of her scalp, rivers of sweat collected around her neck. Only when she became principal of the Madras school was she allowed to open her own letters.

Eventually, it became too much. Through letters to her sister, Peggie, who turns out to be Mr Lanchester's best informant, he tells of Sister Eucharia's stirrings for freedom and her final disenchantment with the convent. She wangled dispensation from Rome, and arrived back in London yearning to be a woman.

Not only did she succeed in this, she became a mother, too: Mr Lanchester's. Among her new adventures, Julia acquired a British passport that cut nine years from her 40 so that in 1961 she could become Mrs Bill Lanchester (he was six years younger than her real age). John was born within a year.

To match his mother's pre-marriage life, Mr Lanchester junior draws the early years of his father, who was dispatched to Australia for schooling while his parents settled into colonial life in Hong Kong. The author, who wrote with elan about Hong Kong in his novel "Fragrant Harbour", does so again with fine depictions of his grandparents' internment by the Japanese in wartime Hong Kong.

He uses his imagination to describe his mother's feelings as a banker's wife after years cloistered in a netherworld. She lived a pampered life of cocktails and dinner parties, never telling her secrets. Her Irish family thought her makeover as Mrs Lanchester in faraway Hong Kong a form of snobbery. The author says it was simple fear of exposure.

It is after his father's early retirement and his parents' return to England that Mr Lanchester does less well. Suddenly, the story becomes a rambling psychological study of the author himself. Too bad that an editor did not excise the self-pitying self-portrait that unconvincingly brings to an end the strange undercurrents of this unusual family memoir.

Family Romance: A Love Story.
By John Lanchester.
Putnam; 384 pages; $27.95.
Faber and Faber; £16.99

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New theatre

King of the Hill

May 17th 2007 | NEW YORK
From The Economist print edition

August Wilson's last play

Carol Rosegg

Jelks (left) and Chisholm weave their magic

IN THE late 1960s, a 23-year-old high-school dropout founded a theatre troupe in Pittsburgh's Hill District, the predominantly black neighbourhood where he had grown up. He took to writing. One of his earliest works was a play set in a ramshackle gypsy-cab office in which little happened: a bunch of guys trade stories, swap insults, talk about the world. At some point, however, it became plain that all this was not really the playwright's characters talking about the world so much as he, August Wilson, doing what great writers do: building a world through his characters' words.

Revised and polished over two decades, that work became “Jitney”, part of an ambitious series of ten plays, each set in a different decade of the 20th century and all save one in the Hill District. These, known as the Pittsburgh Cycle, earned Wilson almost every award a playwright can win. To describe the plays as telling the story of the American black experience is true, but it sounds too high-minded. Wilson had a golden ear for the cadence and humour of everyday speech, and the way his characters reveal themselves through language provides a pleasure unmatched on the American stage.

“Radio Golf” is the cycle's final chapter in two senses: it is set in the century's last decade, and Wilson died soon after completing it. Its protagonist, Harmond Wilks, is anomalous among Wilson characters: he is middle-class, politically ambitious and a true believer in the American legal and political systems. The play is a battle for his soul.

On one side are his flashy business partner, Roosevelt Hicks, and Wilks's savvy wife, Mame. Hicks and Wilks want to “bring the Hill back” by building an apartment and retail complex on the site of some abandoned row houses. On the other side are two older neighbourhood guys: Old Joe, who has a claim on one of the houses Wilks wants to pull down, and Sterling Johnson, a street-smart handyman. Metaphorically, this is a battle for the black community in the late 20th century: a struggle to maintain black cohesion in the face of economic incentives and a sort of spiritual gentrification.

Dramatically, this play may be Wilson's thinnest: the lines between good and evil are too starkly drawn, and the claim that redevelopment has been uniformly regrettable for black Americans is simply untrue. But the plot is almost beside the point. Wilson has turned the Hill into a place as richly peopled and mythologically deep as Faulkner's Yoknapatawpha county: the house that Old Joe believes he owns belonged to Aunt Ester, who died at the great age of 349. Ester was the spiritual centre of Wilson's Hill neighbourhood. Though she appeared in only one play, she is spoken of in all of them. Sterling Johnson was a young hot-head in “Two Trains Running”, Wilson's 1960s play. In this one John Jelks gives him depth, toughness and wonderful comic timing.

The outstanding performance, though, belongs to Anthony Chisholm, who invests Old Joe with a heart-breaking humanity. His recollection of having a flag torn off his army uniform mixes sadness, outrage and poetry in a manner that is quintessentially Wilsonian.

"Radio Golf" is at the Cort Theatre in New York.

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Alfred Chandler

May 17th 2007
From The Economist print edition

Alfred Chandler, chronicler of corporations, died on May 9th, aged 88

Harvard Business School

TODAY'S business leaders are voracious consumers of management advice. They are forever calling in the consultants and surfing the business press for the next big thing. So here is a free tip. Get off the whirligig of management fads. Forget about “long tails” and “wikinomics” for a while and do something old-fashioned. Sit down with a handful of books—admittedly rather fat books—and contemplate the life's work of Alfred Chandler.

Mr Chandler was the dean of American business historians, the man who more or less invented the history of the big corporation. But he was more than an ivory-tower academic. For much of his life he taught at Harvard Business School, where he made business history mainstream. (In 1970, when he arrived, few took the course; in time, hundreds enrolled.) This gave his work a sharp practical edge.

He influenced a generation of consultants with his insistence that structure must follow strategy—that changes of strategy can be successful only if managers are willing to wrench their organisations into new forms. His fingerprints are all over one of the 20th century's classic business books, “My Years with General Motors” by Alfred Sloan. (Mr Chandler ascribed his habit of drinking sherry every lunchtime to Sloan's influence. Sloan used to hit the martinis at lunch when they were working on the book together. The younger historian thought it more prudent to stick to sherry.)

Mr Chandler could easily have missed his vocation. He was born into a patrician family in Delaware, and remained passionate about patrician sports: some of the best duck-hunting anywhere, he would say, was found round Guantánamo Bay. At the height of the Depression he went with his family on a year-long cruise to the Galápagos. He liked to show visitors a photograph of the Harvard sailing team of 1940, a group of five handsome young men in ties and jackets that included himself and Jack Kennedy.

His teachers thought he should do Greek, but three things pushed him into the vulgar calling of studying how businesses work. The first was his wartime interest in how large outfits like the navy (in which he served) operated. The second was the influence of local legends such as Talcott Parsons and Joseph Schumpeter. The third was his family heritage. Mr Chandler's patrician friends in Delaware included the mighty du Pont family.

Yet his academic career might still not have started without a piece of luck: the discovery, in a storeroom in the house of a recently deceased great-aunt, of the papers of one of his ancestors, Henry Varnum Poor

(of the Standard & Poor's Corporation). Poor was the leading analyst of the most important industry of his day, the railways, and his papers provided Mr Chandler with the substance of his PhD and the start of his life's work: the history of big business as an organisational form.

Managers as heroes

Giant corporations, he argued, arose in the late 19th century as a result of the integration of mass production and mass distribution. They swept all before them with their superior management techniques, relentlessly internalising transactions that had previously been done by the market, and they continued to evolve and expand, adapting new forms to deal with new problems. The 1920s saw the rise of multi-division firms—notably Sloan's General Motors—that welded separate business sections into a co-ordinated enterprise.

Mr Chandler's massive body of research—particularly “Strategy and Structure” (1962), “The Visible Hand” (1977) and “Scale and Scope” (1990)—took serious issue with some of the basic assumptions of economics. He questioned Adam Smith's emphasis on the invisible hand. He argued instead that, from the late 19th century onwards, the role of co-ordinating economic activities passed from the marketplace to the visible hand of managers. For Mr Chandler it was managers, patiently building and running large organisations, who were the real heroes of the industrial age, and not fly-by-night entrepreneurs, as some romantics taught.

He also challenged the reigning assumption that oligopolies were inherently inefficient. On the contrary, he argued, the industries that drove economic growth for much of the 20th century—oil and chemicals, cars and electronics—were quickly dominated by a small number of vertically integrated firms that nevertheless continued to grow and innovate. These companies were successful precisely because they were able to make huge investments in management and production.

Many now believe that Mr Chandler's era of “managerial capitalism” has come to an end. Companies are getting smaller and businesses are being disaggregated. But this hardly makes his views irrelevant. There is no better way to understand the era of unbundling than to study the era of bundling that came before it. And firms like Toyota and Microsoft, exploiting economies of scale, are still behaving much like the companies he celebrated.

He himself was a warning against taking the unbundling fad too far. Brilliant and productive though he was, he would not have been the same Alfred Chandler without the leviathan of the Harvard Business School behind him.

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Overview

May 17th 2007
From The Economist print edition

In **America** consumer prices rose by 0.4% in April. Core prices, which exclude energy and food, rose by only 0.2%, bringing down the annual rate to 2.3%. Industrial production picked up, rising by 0.7% in April, well above the 0.3% increase the markets had been expecting. But the housing downturn intensified as the number of building permits dropped to a ten-year low.

Euro-area inflation was revised up to 1.9% for the year to April from the preliminary estimate of 1.8%. That left it unchanged compared with March. Inflation in the single-currency area in April ranged from 1.3% in France to 2.9% in Ireland and Slovenia. The initial estimate for euro-area GDP showed that it increased by 0.6% in the first quarter of 2007 compared with the previous three months. That left it 3.1% higher than in the first quarter of 2006.

In **Britain** the annual rate of consumer-price inflation, which had risen in March to 3.1%, triggering an explanatory letter from the Bank of England, fell back to 2.8% in April. Forecasts published by the bank on May 16th suggested that the base interest rate, which it raised earlier this month to 5.5%, would rise to 5.75% later this year. Earnings growth dipped from 4.6% to 4.5% in the three months to March compared with the same period a year earlier.

In **China** consumer-price inflation fell to 3.0% in the 12 months to April.

Indian industrial production rose by 12.9% in the year to March.

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Output, prices and jobs

May 17th 2007
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2007†	2008†	latest	latest	year ago	2007†	rate‡, %
United States	+2.1 Q1	+1.3	+2.1	+2.7	+1.9 Apr	+2.6 Apr	+3.5	+2.4	4.4 Mar
Japan	+2.0 Q1	+2.4	+2.4	+2.2	+1.6 Mar	–0.1 Mar	–0.2	+0.0	4.0 Mar
China	+11.1 Q1	na	+10.3	+9.7	+17.6 Mar	+3.0 Apr	+1.2	+2.8	9.8 2006
Britain	+2.8 Q1	+2.6	+2.7	+2.5	–0.2 Mar	+2.8 Apr**	+2.0	+2.3	5.5 Mar††
Canada	+2.3 Q4	+1.4	+2.3	+2.7	–1.2 Feb	+2.3 Mar	+2.2	+1.9	6.1 Apr
Euro area	+3.1 Q1	+2.4	+2.4	+2.1	+3.7 Mar	+1.9 Apr	+2.4	+1.9	7.2 Mar
Austria	+3.2 Q1	+3.2	+2.8	+2.6	+8.6 Feb	+1.8 Apr	+1.9	+1.6	4.4 Apr
Belgium	+2.8 Q1	+2.4	+2.4	+2.2	+3.4 Feb	+1.8 Apr	+2.0	+1.8	11.2 Mar‡‡
France	+2.1 Q1	+2.4	+2.1	+2.1	+1.1 Mar	+1.3 Apr	+1.7	+1.4	8.3 Mar
Germany	+3.6 Q1	+2.1	+2.3	+2.1	+7.7 Mar	+1.9 Apr	+2.0	+1.8	9.2 Apr
Greece	+4.6 Q1	na	+3.3§	+3.2§	+0.1 Mar	+2.5 Apr	+3.3	+2.9§	8.6 Jan
Italy	+2.3 Q1	+0.8	+1.9	+1.6	+1.6 Mar	+1.5 Apr	+2.2	+1.9	6.5 Q4
Netherlands	+2.5 Q1	+2.3	+2.6	+2.5	+5.8 Mar	+1.8 Apr	+1.6	+1.6	4.7 Apr††
Spain	+4.0 Q1	+4.1	+3.5	+2.8	+2.3 Mar	+2.4 Apr	+3.9	+2.6	8.6 Mar
Czech Republic	+5.8 Q4	+5.8	+5.3	+4.9	+12.7 Mar	+2.5 Apr	+2.8	+2.6	6.8 Apr
Denmark	+2.9 Q4	+1.5	+2.3	+2.3	+6.1 Mar	+1.7 Apr	+1.8	+1.9	3.9 Mar
Hungary	+2.9 Q1	+2.8	+2.6	+3.1	+6.8 Mar	+8.8 Apr	+2.3	+6.8	7.5 Mar††
Norway	+2.7 Q4	+2.0	+2.8§	+2.5§	–4.0 Mar	+0.3 Apr	+2.7	+1.6§	2.7 Mar††
Poland	+6.4 Q4	na	+6.0	+5.3	+11.3 Mar	+2.3 Apr	+0.7	+2.2	14.4 Mar‡‡
Russia	+7.9 Q1	na	+6.7	+6.4	+7.9 Mar	+7.8 Apr	+10.0	+8.2	7.2 Mar‡‡
Sweden	+4.7 Q4	+5.0	+3.8	+3.1	+9.0 Mar	+1.9 Apr	+1.5	+1.6	4.8 Mar‡‡
Switzerland	+2.2 Q4	+1.8	+2.1	+2.0	+8.9 Q4	+0.5 Apr	+1.1	+0.6	2.9 Apr‡‡
Turkey	+5.2 Q4	na	+4.6	+5.7	+2.6 Mar	+10.7 Apr	+8.8	+8.3	9.6 Q4‡‡
Australia	+2.8 Q4	+4.2	+3.0	+3.2	+3.7 Q4	+2.4 Q1	+3.0	+2.6	4.4 Apr
Hong Kong	+7.0 Q4	+5.3	+5.3	+4.9	–1.4 Q4	+2.4 Mar	+1.6	+2.4	4.3 Mar††
India	+8.6 Q4	na	+8.1	+7.6	+12.9 Mar	+6.7 Mar	+4.9	+5.7	7.6 2006
Indonesia	+6.1 Q4	na	+6.0	+5.8	–5.2 Feb	+6.3 Apr	+15.4	+6.5	10.3 2005
Malaysia	+5.7 Q4	na	+5.4	+5.6	–2.7 Mar	+1.5 Apr	+4.6	+2.3	3.0 Q4
Pakistan	+6.6 2006§§	na	+6.9§	+6.0§	+6.8 Sep	+6.9 Apr	+6.2	+6.7§	na
Singapore	+6.0 Q1	+7.2	+5.5	+5.7	–2.9 Mar	+0.7 Mar	+1.2	+1.6	2.9 Q1
South Korea	+4.0 Q1	+3.6	+4.3	+4.6	+3.1 Mar	+2.5 Apr	+2.0	+2.2	3.3 Apr
Taiwan	+4.0 Q4	na	+4.2	+4.6	+0.1 Mar	+0.7 Apr	+1.2	+1.3	3.9 Mar
Thailand	+4.2 Q4	+2.7	+4.0	+4.7	+4.0 Mar	+1.8 Apr	+6.0	+2.5	1.5 Feb
Argentina	+8.6 Q4	+7.4	+7.5	+5.7	+3.7 Mar	+8.9 Apr	+11.6	+9.8	9.7 Q1‡‡
Brazil	+3.8 Q4	+4.5	+3.9	+3.7	+3.9 Mar	+3.0 Apr	+4.6	+3.6	10.1 Mar‡‡
Chile	+4.3 Q4	+7.8	+5.2	+5.1	+5.2 Mar	+2.5 Apr	+3.8	+2.6	6.7 Mar††††
Colombia	+8.0 Q4	nil	+5.4	+4.6	+14.6 Feb	+6.3 Apr	+4.1	+5.1	12.0 Mar‡‡
Mexico	+4.3 Q4	+1.9	+3.2	+3.8	nil Feb	+4.0 Apr	+3.2	+3.8	4.0 Mar‡‡
Venezuela	+11.8 Q4	na	+6.6	+3.9	+6.7 Jan	+19.4 Apr	+11.4	+17.6	8.9 Q4‡‡
Egypt	+7.1 Q3	na	+6.3	+5.6	+10.5 2006	+12.8 Mar	+3.7	+9.9	9.0 Q4‡‡
Israel	+3.7 Q4	+8.0	+4.7	+4.3	+8.4 Feb	–0.9 Mar	+3.6	+0.9	7.7 Q4
Saudi Arabia	+3.4 2006§	na	+4.0§	+5.0§	na	+3.0 Feb	+1.6	+2.5§	na
South Africa	+6.1 Q4	+5.6	+4.8	+4.9	+5.2 Mar	+6.1 Mar	+3.4	+5.4	25.5 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	+9.9 Q1	+9.5	+9.4§	+7.4§	+7.4 Mar	+5.5 Apr	+4.3	+5.1§	4.9 Mar
Finland	+5.3 Q4	+3.8	+2.7§	+2.5§	–0.1 Mar	+2.6 Apr	+1.3	+1.4§	7.2 Mar
Iceland	+2.5 Q4	+7.8	+1.3§	+2.7§	na	+4.7 May	+7.6	+5.0§	1.3 Mar‡‡
Ireland	+5.0 Q4	+0.1	+5.4§	+3.6§	+10.7 Mar	+5.1 Apr	+3.7	+3.4§	4.2 Mar
Latvia	+10.7 Q1	na	+9.2§	+7.5§	+1.0 Mar	+8.9 Apr	+6.1	+6.0§	5.8 Feb
Lithuania	+7.1 Q1	+6.1	+6.5§	+6.4§	na	+4.8 Apr	+3.4	+1.9§	6.2 Feb
Luxembourg	+5.0 Q4	+7.0	+4.6§	+4.9§	+0.4 Jan	+2.1 Mar	+3.0	+2.2§	4.6 Mar‡‡
New Zealand	+2.9 Q4	+5.0	+3.1§	+3.1§	–0.4 Q4	+2.5 Q1	+3.3	+2.2§	3.8 Q1
Peru	+7.4 Feb	na	+6.7	+5.6	+7.2 Feb	–0.1 Apr	+2.9	+1.1	9.5 Feb‡‡
Philippines	+6.5 Q4	+5.6	+5.7	+5.8	–10.3 Feb	+2.3 Apr	+7.1	+3.9	7.3 Q4‡‡
Portugal	+2.1 Q1	+3.2	+1.6§	+2.1§	+1.8 Mar	+2.3 Mar	+3.9	+2.2	8.2 Q4‡‡
Slovakia	+8.9 Q1	na	+8.0§	+5.6§	+12.5 Mar	+2.7 Apr	+4.5	+2.5	11.2 Feb
Slovenia	+5.5 Q4	na	+4.7§	+4.1§	+9.3 Mar	+2.6 Apr	+2.7	+2.3	8.1 Mar‡‡

*% change on previous quarter, annual rate. †*The Economist* poll. ‡National definitions. §Economist Intelligence Unit estimate/forecast. **RPI inflation rate 4.5% in Apr. ††Latest three months. ‡‡Not seasonally adjusted. §§Year ending June.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

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The Economist commodity-price index

May 17th 2007
From The Economist print edition

The Economist commodity-price index

2000=100

	May 8th	May 15th*	% change on one month	% change on one year
Dollar index				
All items	202.9	204.3	+2.0	+12.1
Food	155.9	161.8	+2.5	+15.8
Industrials				
All	263.7	259.2	+1.5	+9.2
Nfa†	158.2	159.0	–0.8	+1.4
Metals	321.2	313.8	+2.2	+11.6
Sterling index				
All items	154.6	156.1	+3.1	+6.5
Euro index				
All items	138.7	138.9	+1.8	+5.9
Gold				
$ per oz	686.05	672.55	–2.3	–2.4
West Texas Intermediate				
$ per barrel	62.21	63.00	–0.1	–9.1

*Provisional †Non-food agriculturals.

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Producer prices

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From The Economist print edition

Producer prices, which are measured at the factory gate, used to be closely watched because they gave advance notice of inflation coming down the pipeline. Over the past couple of years, they have risen fast owing to higher commodity prices. The increase in the past 12 months has been especially marked in Sweden and Canada, where producer prices have gone up by around 5%. Despite this, manufacturers have been managing to absorb much of the rise in their input costs. Furthermore, fierce competition between retailers has also been dampening the extent to which price rises pass from the factory gate to the high street. Pipeline inflation is just not what it used to be.

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Trade, exchange rates, budget balances and interest rates

May 17th 2007
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2007†	Currency units, per $ May 16th	Currency units, per $ year ago	Budget balance % of GDP 2007‡	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	–827.2 Mar	–856.7 Q4	–6.1	–	–	–1.7	5.18	4.71
Japan	+89.8 Mar	+181.5 Mar	+4.0	121	110	–4.5	0.57	1.66
China	+207.3 Apr	+249.9 2006	+8.1	7.68	8.00	–1.5	2.97	3.65
Britain	–157.6 Mar	–80.1 Q4	–3.0	0.50	0.53	–2.6	5.72	5.10
Canada	+46.3 Mar	+21.4 Q4	+1.1	1.10	1.11	1.3	4.15	4.25
Euro area	–6.4 Feb	–5.1 Feb	–0.1	0.74	0.78	–1.0	4.07	na
Austria	+0.6 Feb	+10.3 Q4	+1.9	0.74	0.78	–0.9	4.07	4.34
Belgium	+18.3 Feb	+7.8 Dec	+1.8	0.74	0.78	nil	4.12	4.36
France	–34.2 Mar	–32.2 Mar	–1.3	0.74	0.78	–2.7	4.07	4.34
Germany	+220.4 Mar	+165.0 Mar	+4.9	0.74	0.78	–0.3	4.07	4.29
Greece	–45.7 Feb	–31.5 Feb	–8.1†	0.74	0.78	–2.2	4.07	4.48
Italy	–25.2 Feb	–47.1 Feb	–1.9	0.74	0.78	–2.6	4.07	4.50
Netherlands	+43.4 Mar	+59.7 Q4	+7.6	0.74	0.78	0.5	4.07	4.33
Spain	–115.9 Feb	–112.1 Feb	–8.8	0.74	0.78	1.4	4.07	4.35
Czech Republic	+2.6 Mar	–6.1 Q4	–3.8	20.7	22.1	–4.3	2.77	4.28
Denmark	+6.4 Mar	+5.5 Mar	+2.5	5.49	5.83	3.1	4.32	4.35
Hungary	–2.0 Mar	–6.5 Q4	–4.7	184	206	–6.7	7.78	6.53
Norway	+54.3 Apr	+56.1 Q4	+14.9†	6.01	6.11	18.7	4.59	4.87
Poland	–5.3 Feb	–8.2 Feb	–2.6	2.80	3.07	–2.4	4.44	5.30
Russia	+131.3 Mar	+85.8 Q1	+5.7	25.8	27.0	5.5	10.50	6.14
Sweden	+20.1 Mar	+28.4 Q4	+6.6	6.77	7.33	2.2	3.26	4.14
Switzerland	+10.4 Mar	+106.1 Q4	+15.9	1.22	1.21	0.3	2.41	2.90
Turkey	–53.5 Mar	–32.1 Mar	–7.0	1.33	1.48	–2.7	19.28	18.62
Australia	–10.2 Mar	–40.9 Q4	–5.3	1.21	1.31	1.3	6.38	5.89
Hong Kong	–18.2 Mar	+20.2 Q4	+9.8	7.82	7.75	2.6	4.41	4.07
India	–58.2 Mar	–10.0 Q4	–1.8	40.8	45.2	–3.5	7.58	8.42
Indonesia	+41.1 Mar	+9.6 Q4	+2.2	8,805	9,065	–1.2	8.54	6.25§
Malaysia	+28.6 Mar	+25.6 Q4	+13.5	3.40	3.58	–3.7	3.62	5.26§
Pakistan	–13.6 Apr	–6.5 Q4	–5.6†	60.7	60.0	–4.0	9.84	6.72§
Singapore	+34.4 Mar	+36.3 Q4	+23.3	1.52	1.57	0.3	2.44	2.59
South Korea	+17.2 Apr	+5.7 Mar	+0.2	924	937	0.6	5.03	5.11
Taiwan	+13.0 Apr	+25.2 Q4	+6.7	33.4	31.6	–2.3	1.86	2.19
Thailand	+6.6 Mar	+8.1 Mar	+2.1	34.6	38.1	–1.4	3.95	3.51
Argentina	+11.7 Mar	+8.1 Q4	+2.5	3.07	3.04	1.4	9.50	na
Brazil	+46.7 Apr	+13.6 Mar	+0.8	1.96	2.17	–2.4	12.43	6.16§
Chile	+24.0 Apr	+5.3 Q4	+1.3	517	521	4.8	5.04	5.25§
Colombia	–0.9 Feb	–2.9 Q4	–2.7	1,997	2,432	–0.9	7.36	5.96§
Mexico	–9.2 Mar	–1.5 Q4	–1.4	10.8	11.1	–0.2	7.23	7.70
Venezuela	+33.0 Q4	+27.2 Q4	+9.8	2,147	2,539	–4.9	10.12	6.55§
Egypt	–12.6 Q4	+2.7 Q4	+1.5	5.69	5.76	–7.6	6.90	5.29§
Israel	–7.8 Apr	+6.8 Q4	+3.6	3.94	4.44	–2.0	3.82	4.22
Saudi Arabia	+148.5 2006	+95.4 2006	+20.1†	3.75	3.75	15.4	5.05	na
South Africa	–9.5 Mar	–16.3 Q4	–6.0	6.95	6.37	0.5	9.70	7.61
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*							
Estonia	–3.6 Feb	–2.7 Feb	–14.5†	11.5	12.2	4.1	4.38	na
Finland	+11.6 Feb	+13.7 Mar	+5.7†	0.74	0.78	2.3	4.04	4.33
Iceland	–1.8 Apr	–4.4 Q4	–20.1†	62.9	70.4	1.8	13.72	na
Ireland	+33.6 Feb	–7.2 Q4	–4.3†	0.74	0.78	1.0	4.07	4.31
Latvia	–5.3 Feb	–4.8 Feb	–23.1†	0.51	0.54	nil	8.70	na
Lithuania	–5.7 Mar	–3.6 Feb	–10.3†	2.54	2.70	–0.5	4.93	na
Luxembourg	–5.3 Feb	+4.4 Q4	na	0.74	0.78	–0.8	4.07	na
New Zealand	–3.8 Mar	+6.2 Q4	–10.2†	1.36	1.61	3.2	6.95	6.12
Peru	+9.0 Mar	+2.5 Q4	+1.8	3.17	3.26	0.3	4.50	na
Philippines	–4.0 Feb	+5.0 Dec	+3.6	47.0	52.1	–0.8	5.94	na
Portugal	–23.0 Feb	–17.8 Feb	–7.7†	0.74	0.78	–3.3	4.07	4.42
Slovakia	–2.5 Mar	–3.9 Jan	–4.3†	24.9	29.4	–3.0	3.96	4.24
Slovenia	–1.9 Mar	–1.4 Feb	–2.2†	0.74	0.78	–1.1	na	na

*Merchandise trade only. †*The Economist* poll. ‡Economist Intelligence Unit forecast. §Dollar-denominated bonds.

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

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Markets

May 17th 2007
From The Economist print edition

Markets

	Index May 16th	% change on one week	% change on Dec 29th 2006 in local currency	% change on Dec 29th 2006 in $ terms
United States (DJIA)	13,487.5	+0.9	+8.2	+8.2
United States (S&P 500)	1,514.1	+0.1	+6.8	+6.8
United States (NAScomp)	2,547.4	–1.1	+5.5	+5.5
Japan (Nikkei 225)	17,529.0	–1.2	+1.8	–0.5
Japan (Topix)	1,711.9	–1.9	+1.8	–0.4
China (SSEA)	4,175.9	–0.9	+48.3	+55.8
China (SSEB, $ terms)	330.6	+22.4	+141.8	+154.1
Britain (FTSE 100)	6,559.5	+0.2	+5.4	+21.8
Canada (S&P TSX)	14,025.0	+0.9	+8.7	+15.1
Euro area (FTSE Euro 100)	1,387.6	+0.1	+8.5	+24.9
Euro area (DJ STOXX 50)	4,422.6	–0.1	+7.3	+23.5
Austria (ATX)	4,767.3	+1.1	+6.8	+22.9
Belgium (Bel 20)	4,673.3	–0.9	+6.5	+22.5
France (CAC 40)	6,017.9	–0.6	+8.6	+25.0
Germany (DAX)*	7,481.3	+0.1	+13.4	+30.5
Greece (Athex Comp)	4,868.3	+2.6	+10.8	+27.5
Italy (S&P/MIB)	43,802.0	–0.1	+5.7	+21.6
Netherlands (AEX)	527.6	–1.3	+6.5	+22.6
Spain (Madrid SE)	1,646.0	+1.6	+5.9	+21.8
Czech Republic (PX)	1,816.2	–0.8	+14.3	+35.7
Denmark (OMXCB)	468.1	–0.6	+10.4	+27.1
Hungary (BUX)	25,546.4	–1.1	+2.8	+19.8
Norway (OSEAX)	545.2	+0.3	+8.5	+22.2
Poland (WIG)	59,588.9	–0.9	+18.2	+37.7
Russia (RTS, $ terms)	1,856.6	–3.0	–13.4	–3.4
Sweden (Aff.Gen)	401.9	+1.2	+10.0	+29.3
Switzerland (SMI)	9,357.5	–0.7	+6.5	+15.2
Turkey (ISE)	45,539.7	+1.0	+16.4	+18.6
Australia (All Ord.)	6,301.1	–0.6	+11.6	+25.5
Hong Kong (Hang Seng)	20,937.3	+0.4	+4.9	+4.0
India (BSE)	14,127.3	+2.5	+2.5	+13.1
Indonesia (JSX)	2,063.8	+1.3	+14.3	+27.7
Malaysia (KLSE)	1,352.4	+0.1	+23.4	+37.1
Pakistan (KSE)	12,258.9	–1.1	+22.1	+20.3
Singapore (STI)	3,501.2	+1.4	+17.3	+28.2
South Korea (KOSPI)	1,600.6	+0.5	+11.6	+22.1
Taiwan (TWI)	7,988.6	–0.8	+2.1	+0.5
Thailand (SET)	721.7	+2.2	+6.2	+25.9
Argentina (MERV)	2,162.9	+0.4	+3.5	+1.9
Brazil (BVSP)	51,737.0	+0.9	+16.3	+38.8
Chile (IGPA)	14,188.4	–2.2	+14.7	+13.5
Colombia (IGBC)	10,389.9	–0.9	–6.9	+6.6
Mexico (IPC)	30,341.3	+1.2	+14.7	+13.2
Venezuela (IBC)	41,091.1	–7.0	–21.3	–5.3
Egypt (Hermes)	66,222.1	–2.7	+8.0	+9.0
Israel (TA-100)	1,112.0	+2.3	+20.6	+41.1
Saudi Arabia (Tadawul)	7,560.4	+2.2	–4.7	–4.7
South Africa (JSE AS)	28,046.8	–1.1	+12.6	+2.7
Europe (FTSEurofirst 300)	1,581.5	–0.2	+6.6	+22.7
World, dev'd (MSCI)	1,598.2	–0.3	+7.7	+7.7
Emerging markets (MSCI)	1,003.9	+0.5	+10.0	+10.0
World, all (MSCI)	396.9	–0.2	+7.9	+7.9
World bonds (Citigroup)	666.8	–0.4	+1.3	+1.3
EMBI+ (JPMorgan)	421.9	nil	+3.6	+3.6
Hedge funds (HFRX)	1,337.1	nil	+4.8	+4.8
Volatility, US (VIX)	13.5	12.9	11.6	(levels)
CDSs, Eur (iTRAXX)†	18.1	–3.0	–15.2	–2.4
CDSs, N Am (CDX)†	31.4	–2.3	+6.8	+6.8
Carbon trading (EU ETS) €	0.26	–39.5	–95.9	–95.3

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CME; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac.

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Innovation

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Japan is the world's most innovative country, according to a report from the Economist Intelligence Unit, a sister company. It gets the top score in an index, ranging from 1 to 10, which is based on patents per person. The report casts light on the factors behind innovation. Based on a survey of 485 senior executives around the world, it indicates that the top determinants are the technical skills of a country's workforce and the quality of its telecoms and information-technology infrastructure. It also suggests that, despite India's success in IT services, China has better conditions for innovation. The return on innovation is greater in middle-income countries like Mexico than among richer nations.

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